

Abacus

A Journal of Accounting, Finance
and Business Studies

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EDITORIAL

FORTY YEARS 'ON THE FRINGE'

This issue marks *Abacus*' fortieth year of continuous publication. From its founding (see Wells, 2000) it has focused on research that examines more than simply the explanation of practice. It has especially emphasized 'international studies on accounting'—a prescient goal given the new millennial move to have convergence of international accounting standards by the middle of its first decade. Chambers (2000) noted that his work was always 'on the fringe' as it questioned the status quo. In 'In Quest of a Framework' (1995, p. 11) he observed that academic 'pursuit without research traditions is apt to adopt curious notions of what research is all about. My quest for a framework made use of a variety of methods of inquiry, as does all sustained investigation.' That quest saw Chambers examine large samples, total populations and small samples with equal rigour. Drawing on the ideas of an eminent scientist, Beveridge (1950/1957, 140), Chambers (1995, p. 11) notes that 'more discoveries have arisen from intense observation of very limited material than from statistics applied to large groups'. He continues, noting that:

There is a tendency to denigrate inquiries made in respect of small samples, or the use of singular instances (sample: $n = 1$), calling them anecdotal, pejoratively. But there is one thing about single instances: they are real (empirical) in a sense in which an average, mean or mode (or any other statistic) are not, since they are all mental constructs. There are some who believe that if an inquiry leads to a prescription or a specification for a device, it is not a scientific inquiry. But there is no way of testing the result of an inquiry better than seeing if 'it works'—which requires that 'it' be constructed. There is a tendency among some to suppose that a problem is not worthy of attention unless its elements can be quantified. But logicians, mathematicians, economists, physicists, and others have repeatedly pointed out the pitfalls of over-reliance on quantification and statistical manipulation. Said Simon: 'Every science is subject to the ever present danger of turning into mindless, automatic science—compute a t-statistic and a chi-square statistic, and then you're done. . . . What you have to fight for continually is that at least some people spend some of their time thinking.' (1990, 663). Thinking: that's research! (pp. 11–12)

Formed in 1965, *Abacus* enabled Chambers to pursue the above 'quest' as well as satisfy his broader desire to promote rigorous thinking about accounting practice. From its inception the *Abacus* editorial policy objective has been to seek 'publication of exploratory constructive and critical articles on all aspects of accounting and those phases of the theory and administration of organizations and of economic behaviour generally which are related to accounting, finance and business studies'.

For four decades *Abacus* has epitomized Chambers' quest for framework, notwithstanding the guidance of several editors, viz. Chambers (1965–74); Murray Wells

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(1975–94, with assistant editor support from Frank Clarke since 1983 and Graeme Dean, 1986–94); Graeme Dean (1991–4) as co-editor, and editor (1994–present) with continuing assistance from Frank Clarke and Murray Wells as guest and consulting editors. The consistency of Chambers' initial editorial thought is perhaps unsurprising, as all subsequent editors have been unashamedly Chambers' disciples. Zeff (1996) has noted the various approaches underpinning the editing of the major academic accounting journals, with journals such as *Accounting, Organizations and Society* and *Abacus* having substantially consistent editorial thought over many decades, while others, such as *The Accounting Review* and *Accounting and Business Research*, changing as the editorial 'gatekeepers' changed, often every three to five years.

The recent brouhaha concerning the lack of quality in accounting practices and regulation generally is further evidence that the need to pursue Chambers' quest is as strong now as it was in the 1950s and the 1960s. Hence there will be continuing demands on full-time and *ad hoc* referees for *Abacus*. Over the last forty years the effective administration of *Abacus* would not have been possible without the efforts of a strong editorial board. That board has grown over those decades to around thirty today. Its composition clearly reinforces the desire to have an internationally recognized board of scholars, with varied academic interests. It provides a signal to accounting researchers that the objective of *Abacus* to publish eclectic works, both in topic and method, will be properly administered. On behalf of all past and present editors I express sincere thanks to all those who have served on the board over the last four decades. Their efforts have substantially assisted in forging what appears as *Abacus* today.

The journal's double-blind refereeing policy generally entails assessment of all submissions by two international referees and one local referee. Thus *Abacus* has had to draw on the support of over 200 additional *ad hoc* referees over those forty years. The ongoing level of *ad hoc* refereeing support suggests that *Abacus* continues to be perceived favourably in the international academic community. Numerous rankings exercises across many countries over several decades support that claim. One of the most comprehensive and most recent is the work by Ballas and Theoharakis (2003) which canvassed the views from an international sample of 1,231 accounting academics. Their results placed *Abacus* in the 'Top Ten' journals on a world-wide ranking basis. That followed the high rankings (using different criteria) that *Abacus* has achieved in the annual Anbar Golden Page Awards (see *Abacus*, Editorial, October 2001, for details).

This editorial celebrates *Abacus*' many achievements over forty years, especially as a continuous outlet for the publication of material that others might view as being 'on the fringe'. This editorial is an opportunity to congratulate all those associated with its administration (the various board members, The University of Sydney Accounting Foundation, the publishers Sydney University Press and now Blackwell Publishing, the copy editor for many years, Carl Harrison-Ford, and the journal's administrative assistant for several decades, Sheilah Whyte). Their efforts have ensured that *Abacus*, the fourth oldest academic accounting journal in the world, has survived the last four decades so effectively and has strong prospects for the future.

EDITORIAL

Also, I wish to thank the *ad hoc* reviewers who have been so integrally involved in the administration of *Abacus*. The following list contains the names of such referees in 2002 and 2003 (*refers to multiple reports).

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Burrett, R.*
Capalbo, F.
Carmona, S.
Clinch, G.
Cooke, T.
Edwards, P.
Emmanuel, C.
Frino, A.*
Frost, G.
Geiger, M.
Graves, O. F.*
Gray, R.
Guthrie, J.
Hart, G.
Heaney, R.
Hogan, W.
Holland, J.

Islam, A.
Jaggi, B.
Jones, S.
Lim, S.
Lindsay, D.
Lloyd, P.
Miller, M.
Milne, M.*
Mozes, H.
Mozier, P.
Newberry, S.
O'Connell, B.
Rees, W.
Richardson, S.
Roberts, C.
Srivastava, R.
Steinbart, P.*
Stolowy, H.*
Willett, R.
Wyatt, A.
Ziss, S.

2003

Areni, C.
Arthur, N.
Barton, A.
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Brown, L.
Burrett, R.*
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Carmona, S.
Clinch, G.
Day, R.
De Zort, T.
Frino, A.
Frost, G.*
Geiger, M.

Gray, R.
Gwilliam, C.
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Houghton, K.
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Graeme Dean
The University of Sydney
November 2003

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EDITORIAL

PRINCIPLES VS RULES: TRUE AND FAIR VIEW AND IFRSS

A characteristic of human nature appears to be that if something is said often enough it becomes accepted as if it were true. A case in point, arguably, is the mantra that the universal adoption of international financial reporting standards (IRSSs) by 2005 will purge accounting of its ills. This editorial considers that proposition, especially in the light of the interplay of the quality criteria of 'true and fair' or 'presents fairly' with compliance with IFRSSs.

Following the unexpected corporate collapses of Enron, WorldCom, Vivendi, Parmalat and HIH, numerous legislative initiatives have emerged worldwide, including the Sarbanes-Oxley Act of 2002 in the U.S.A. and Australia's CLERP 9 Bill. The Australian Bill proposes a new co-regulatory regime premised on a 'vision of promoting transparency, accountability and shareholder activism'. It advocates that the regulatory regime generally, and financial reporting system specifically, should be principles-based. Much of the discussion of the corporate governance reforms proposed in the Bill has examined whether the new regulatory regime would achieve a balance between ensuring that confidence in the market is regained through new continuous disclosure mechanisms to inform the securities market more effectively, and a desire not to impose excessive regulations that would stifle the economy's growth.

At the professional practitioner level there is a relentless push for accounting setting convergence. The IASB is seeking to have IFRSSs in place worldwide by 2005. How this will mesh with the drive for a so-called principles-based approach to accounting is problematic.

Debating financial reporting and corporate law reform has a long history. Discussion of this appeared recently in an *Abacus* editorial (Dean, 2002, pp. i-vi). The issue of balancing 're-regulation initiatives' after a bout of deregulation is not new, and nor are the suggestions of commentators that we do not need to strait-jacket the many because of the actions of a few (bad apples). There is a sense of 'presentism' in the current debates—a failure to be aware of similar historical patterns—which raises the likelihood that those who do not learn from history are doomed to repeat the mistakes of the past.

Every U.K. corporate law reform committee of enquiry since around the 1890s has noted that directors are in the main honest, that the regulatory system is working effectively most of the time, and that there is no need for substantial reform... that only tinkering is required. This point is made well in Edwards (1981). In contrast, one should note Chambers' 1991 lament that: 'Piece-meal patching will not make a worm-eaten craft seaworthy; neither will piece-meal

tinkerings of individuals, boards and committees make cost-based valuations trustworthy' (p. 18).

There is an implied premise in many of the submissions to the CLERP 9 Bill of the need to move towards the ideal of a principles-based system of regulation generally, especially in respect of matters like auditor independence and the setting and monitoring of accounting and auditing standards. The IASB's IFRSs are perceived to represent the closest thing to a principles-based regime, with reference to true and fair state of affairs and the need for current value information to inform investors—reliable, relevant, understandable and comparable data—proxied by fair value reporting (e.g., CLERP 9, 2002, p. 112). U.S. standards in contrast are categorized as the archetypical rules-based (black letter) system of reporting, while Australia's regime is categorized as being not quite as far along the continuum as the U.S.

This is contestable, as one cannot find any explanation of principles to which the AASB, IFRS or FASB standards conform. Ultimately, each standards-based regime contains rules that are to be observed, even it would seem if they do not result in the financial reports showing a 'true and fair view' or its equivalent. The only dominant theme underpinning the standards is compulsory compliance! The 'principles v. rules' dichotomy has been substituted for the 'substance over form' dictum preceding it. Just as in the final wash-up the form was the substance, for all practical purposes the rules have become the principles. We should ask 'Why?' of such jockeying with terms. The answer is that principles, rules, substance, form, standards and the like are invoked rather than a statement of the underlying singular and workable quality criterion to apply to the preparation and audit of financial statements. Arguably, 'true and fair'—serviceability—is that singular quality criterion.

The 'true and fair' criterion has long been a cornerstone of British-based corporations law regimes (see Chambers and Wolnizer, 1991, pp. 197–213). As it currently stands, there is considerable confusion as to the primacy of 'true and fair'. The professional accountancy bodies and most accountants and auditors appear to proceed on the assumption that 'true and fair' is a second order imperative, and that primacy lies in compliance with the accounting standards. We have noted elsewhere that even as the Australian Corporations Act is currently worded, that is contestable (Clarke *et al.*, 2003, esp. Chs 1, 2, and pp. 319–21).

Financial position and financial performance are not equivocal notions. Outside of contemporary accounting practice, we would expect virtually everybody to perceive financial position as referring to the relationship between the nature, composition and monetary worth of assets, and the nature, composition and amount of liabilities. Financial performance is properly an explanation of the financial transactions and financial events that have changed the previous financial position to the current. Outside of contemporary accounting practice virtually everybody would also expect that several parties could have the same monetary measure of net assets yet have entirely different financial positions. That is, the notion of liquidity is understood, as is how the mix of assets—liquid and illiquid—affects the capacity to pay debts as they fall due. Almost everybody encounters those issues in their day-to-day affairs.

Compulsory compliance with a prescribed set of practices provides a convenient checklist for accountants, auditors and regulators. But compliance with the current batch of national accounting standards does not provide either regulators or the market with serviceable financial information. On that score virtually every listed company's accounts show neither financial performance nor financial position in the terms just described. Virtually all those companies should have either a qualified auditor's report to that effect, or the necessary information reported in the 'Notes to the Accounts'. Compliance with the IFRSs arguably will not improve the situation.

Consider the situation were 'true and fair' the sole criterion dictating directors' and auditors' reporting and attestation obligations. Explanation of how the statements of financial position and financial performance disclose the matters they are held out to show would fall, and quite properly so, on those who prepared the statements and those who audited them. One might expect that regular, common, profession-wide, tried and proven methods of reporting on the wealth and financial progress of companies would emerge as a matter of professional acumen. That happens in other professional pursuits entailing greater complexity than financial affairs. Indeed, that is how 'professional expertise' develops. Why not in accounting?

It has been suggested that it would be useful and novel if, in the current setting, directors were required to explain in their declaration why the financials showed a true and fair view. At one stage in Australia's CLERP9 Bill legislative process (see CLERP 9, 2003, pp. 74–7) it appeared that a small move towards that approach was likely to be the outcome of the CLERP 9 reforms. The proposed changes followed the unanimous recommendations of the Joint Committee on Public Accounts (JCPAA, 2002). The October 2003 Draft CLERP 9 Bill proposed changes to the Corporations Act, 2001, namely, the repeal of the existing Corporations Act paras 295(4)(a) and (b), and paras 303(4)(a) and (b), and their replacement by the insertion of new paras 298(1A), 303(4)(d), 306((2), 307(a), 308(4)(3B), and 309(5B). Those new paragraphs effectively would have required that, where directors did not think the data in the accounts prepared in accord with the accounting standards showed a true and fair view, they were to insert the necessary additional data in the 'Directors' Report' and explain why those data would set the record right. That would have elicited some very interesting answers!

But in the December 2003 version of the CLERP 9 Bill, those new paragraphs which would have reinforced the primacy of 'true and fair' were dropped. Somewhat surprisingly there is no mention in the Federal Treasurer's Second Reading speech as to why those paragraphs were dropped: This is even more surprising given that the JCPAA inquiry had unanimously endorsed those changes and several submissions to the October 2003 version of the CLERP 9 Bill had viewed the changes favourably. The deletion of those paragraphs in the December 2003 version of the Bill represents an opportunity lost.

It is a reminder that accounting reform remains a tortuous and political process.

Graeme Dean and Frank Clarke
The University of Sydney
April 2004

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EDITORIAL

FORTY PLUS—CONTINUING THE JOURNEY TO 'BETTER FINANCIAL REPORTING'

This issue marks the end of *Abacus*'s fortieth year of continuous publication. Wells (2000) captured the frustrations of the journal's founding by Ray Chambers, while the editorial in February 2004 reviewed what had been achieved in those forty years. It is fitting that this last issue of Volume 40 contains reflections of a contemporary of Chambers, the leading UCLA Berkeley academic, George Staubus. He reviews the measurement methods proposed by Chambers and himself. Chambers no doubt would have disputed aspects of the article, especially the general conclusions that the 'Sydney School' view and the 'decision-usefulness' view 'differ in their starting points, the decision makers addressed, the decisions to be informed, and the populations whose concepts of wealth are accepted'.

There is no doubt that in the spirit of inquiry Chambers would have published this piece and debated Staubus at length in the same issue. Such debates were a feature of the academic journal literature in the 1960s and 1970s. What is probably not as well known is that those debates had a significant private background. A cause of this oversight will be remedied to some extent by the launch, on 15 November 2004, of the Raymond John Chambers Archive, known simply as the Chambers Collection. The materials therein augment The University of Sydney's Fisher Library Foundation Professors series, which seeks to present several insiders' views of the development of Australia's first university. Further, they augment several other similar collections—the existing Louis Goldberg Collection at Deakin University and the proposed Abraham Briloff Collection at NYU. The Chambers Collection adds insights into lengthy 1950s–90s debates between academics and practitioners seeking 'better financial reporting'. (Details of the launch of the R. J. Chambers Collection and the associated 2004 R. J. Chambers Research Lecture appear at the back of this issue.)

The editorial in February this year also observed that *Abacus* has 'especially emphasized "international studies on accounting"—a prescient goal given the new millennial move to have convergence of international accounting standards by the middle of its first decade'. Also, it observed that Chambers formed *Abacus* in 1965 partly to pursue a 'quest' for evidence-based research and partly to satisfy his broader desire to promote 'thinking about accounting thought and practice'. In this regard, the Jones and Welnizer article in this issue provides insights as to how international accounting and market price matters were put on the legislative agenda as part of Australia's CLERP legislation.

In 1965 the *Abacus* editorial policy objective, which continues forty years on, was to seek 'publication of exploratory, constructive and critical articles on all aspects of accounting and those phases of the theory and administration of organizations and of economic behaviour generally which are related to accounting, finance and business studies'. The last issue of Volume 40 continues that tradition. Innovative articles by Gray and Clarke, and by Adams and McPhail, provide, respectively, a new analytical method for determining banks' allowance for loan losses and an examination of banks' and the retail sector's social reporting practices. The latter is based on the experiences of U.K. banks and retail companies in reporting on their employment practices related to minorities. Noguchi and Edwards continue the journal's long tradition in publishing articles on accounting history, examining how the ICAEW dealt with accounting principles, conflict and the state in the post-World War II period.

Chambers' ideas and his journey to achieve 'better financial reporting' continue to be debated widely. The August 2004 issue of the leading international education journal, *Accounting Education*, contains a forum examining one of Chambers' critical works on accounting education, 'The Poverty of Accounting Discourse' (1999). It includes Chambers' 'Poverty' article, first published in *Abacus*, as well as four invited commentaries by Tinker (in press), Mattessich (in press), Amernic (in press) and Lee (in press). Members of the 'Sydney School' (Frank Clarke, Graeme Dean and Peter Wolnizer) were invited to respond to those commentaries (Clarke *et al.*, in press). The Craig and Amernic article in this issue of *Abacus* argues for the need to reform accounting education to rectify Chambers' 'poverty of accounting discourse'.

Completing this issue is an index of *Abacus* articles over the last four years. After four decades, *Abacus* continues to publish works on a myriad of topics, using various research methods and with a broad geographic spread of authors. Chambers' desire to form an internationally recognized journal (Ballas and Theoharakis, 2003) has undeniably been achieved. There are many who would concur with Staubus 'that it has been a pleasure to travel with Ray Chambers on the road to better financial reporting'.

The *Abacus* June 2004 editorial referred to Australia's Federal legislative reforms contained in the December 2003 CLERP 9 Bill (Commonwealth of Australia, 2003). It noted that certain paragraphs which would have reinforced the primacy of the 'true and fair view' criterion had been dropped. Further, it argued that this represented an opportunity lost. As this editorial goes to press Australia's CLERP 9 Bill (the equivalent to the 2002 U.S. Sarbanes-Oxley Act) was enacted. The Act reinserted some of those paragraphs following debate on the recommendations of a Commonwealth of Australia Joint Parliamentary Committee of Inquiry into the CLERP 9 Bill. The Act now reinforces the primacy of the 'true and fair view' criterion. Given similar override clauses already included in, or being proposed for, other countries' legislation (and in some accounting conceptual frameworks) this is an important development in ensuring 'better financial reporting'. The June editorial argued that greater emphasis on principles, such as 'true and fair', would be a useful strategy. Another

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of the Joint Committee's recommendations, if it had been adopted, would have further advanced that cause. The Committee recommended that Australia's corporations legislation include a direction as to what the true and fair view criterion means; namely to direct preparers that data in financial statements should be serviceable for investment and other related decisions, as is required of data included in prospectuses.

Finally, a personal reflection on the last ten years as the full editor of *Abacus*. That period has been extremely rewarding, providing me an opportunity to steer the journal in a manner similar to that of my predecessors. For their training and guidance I shall be forever grateful. But the journey is far from over. Recent unexpected corporate collapses and the accounting irregularities revealed in their aftermath have again confirmed that companies had, in the main, followed approved accounting standards but their financial statements had not depicted their impending financial dilemmas. This is evidence that there is an ongoing need to continue to search for Chambers' and Staubus' 'better financial reporting'.

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June 2004

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MICHELA ARNABOLDI AND IRVINE LAPSLEY

Modern Costing Innovations and Legitimation: A Health Care Study

This article is a study of the introduction of a modern costing technology—activity based costing (ABC)—into a health care organization which is undergoing change. The transformation of this organization is of particular interest as it focused on the experience of a service which had always existed by collecting blood, which is given as a free donation (the gift), and which is then converted into a variety of health care products. Typically, accounting innovations in the U.K.'s National Health Service are at the behest of central government: In this case, the adoption of ABC is on the initiative of the health care organization itself. The attractiveness of the specific costing approach from the perspective of the management of this health care organization is as an ingredient in legitimation—the portrayal of this entity as a 'complete organization'.

Key words: ABC; Gift relationship; Health care; Organization.

The implementation of new management accounting systems within health care organizations has attracted the attention of many researchers (Coombs, 1987; Preston *et al.*, 1992; Jacobs, 1995; Jones and Dewing, 1997; Doolin, 1999; Lapsley, 2001a). This research added to our understanding of the use of management accounting in health care settings. These studies share the distinction of being impact studies which have examined the implementation of government initiatives for new costing and budgeting systems in hospitals. The present study contrasts with the above articles: It examines a health care organization which has sought to implement a specific costing technology, activity based costing—ABC—in the absence of central government guidance.

This research reveals the adoption, rather than the deployment, of this costing technology. Adoption of ABC is shown to be a legitimating exercise, as the organization seeks to portray itself as modern. The organization studied has distinctive attributes, notably its basic raw material is donated blood (which has been described as 'the gift relationship') which has had a fundamental impact on this entity, as discussed below. Moreover, this study emphasizes the importance of the language of accounting in the social construction of what Brunsson and

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Sahlin-Andersson (2000) called the 'complete organization'. The concepts underlying the idea of the complete organization are *mimicry* and *legitimacy*: an exercise in which public sector organizations seek to present themselves as if they operated in a similar fashion to major private sector corporations, which are regarded as 'complete'. In this way the public sector organizations seek to be considered modern and legitimate.

CONTEXT: ABC AND HEALTH CARE

Activity-based costing has achieved a position of some prominence as a technology which can provide managers with sharper costs for product costing, for segments of organizational activity, for product design and for the identification of efficiencies and economies. Such attributes attract many proponents of ABC as a costing system (Shields and McEwan, 1996; Innes *et al.*, 2000). There are also advocates of ABC specifically in the context of public services, including health care (Antos, 1992; Moravec and Yoemans, 1992).

However, there is an emergent literature which depicts the transfer of ABC from the private sector to public services as problematic. Brown *et al.* (1999) discuss the application of ABC in government services and caution against the technical difficulties and resources required and the behavioural difficulties of successful implementation. Mullins and Zorn (1999) also challenge the portability of ABC to the government sector, citing its inappropriateness because it does not fit the public sector, and express serious doubts about the accuracy of the resultant cost allocations.

These misgivings over the transferability of ABC to the public sector are reflected in a new critique of the applicability of ABC to the private sector. At one level, reservations have been expressed about technical difficulties of implementation and also barriers to change when ABC information becomes available (Roberts and Silvester, 1996). However, there are more fundamental reservations over the nature of ABC. In the view of this new wave of critics, ABC emerged from a process in which its proponents highlighted the similarities of their cases and underplayed differences, made selective adoptions of certain features and rejection of others, and all of this in the context of differing interpretations of what constituted ABC (Jones and Dugdale, 2002, p. 158). Further, these researchers challenged the widespread extension of ABC to the public sector, specifically on the grounds that the advocacy of ABC for financial service firms, hospitals and universities did not capture the subtleties of the different kinds of changes which these organizations were experiencing (Jones and Dugdale, 2002, p. 152). Also, Armstrong (2002) depicts ABC as a management tool which does not reveal more accurate cost estimations than conventional techniques of cost allocation, and which has achieved its prominence because of statements of belief. As Armstrong (2002, p. 102) expresses it: 'people do not act according to the situation but according to their definition of it. So has been belief in the reality of activity-based costing. It is this belief which defines the difference between activity-based and absorption costing not differences in computations.'

HEALTH CARE COSTING INNOVATIONS AND LEGITIMATION

Both Armstrong (2002) and Jones and Dugdale (2002) suggest that organizations adopt ABC as a costing technology to portray themselves as 'modern', as a legitimating device. This is particularly apposite for public sector services in the U.K., as the words 'modern' and 'modernization' constitute the leitmotif of public policy towards the reform of the public services (Lapsley, 2001b). Within health care policy, documents resonate with ideas of the 'modern'. See, for example, the first substantive policy document after the election of the Labour government in the U.K. in 1997, the White Paper which portrayed the 'New National Health Service (NHS)—*Modern, Dependable*' (DoH, 1997; emphasis added). This aspect of ABC adoption, the sense of organizations seeking to portray themselves as 'modern' and, thereby, legitimate is of particular interest within the health care context.

When the U.K.'s National Health Service was investigating more sophisticated costing models for health care organizations to facilitate the production of more precise costs to support the internal market which existed in the early 1990s, the National Health Service (NHS) Management Executive commissioned a study to advise it on the appropriateness of ABC for the NHS. That study cautioned against the use of ABC for a variety of reasons, including the set up costs in the complex, multi-product environment of hospitals (King *et al.*, 1994a, 1994b). The NHS Management Executive then went in the direction of costings based on health-related groups (HRGs), a variation of the U.S.-derived diagnostically related groups (DRGs) (see Jones, 1999). Given these developments, the adoption of ABC by a part of the U.K.'s NHS, counter to government guidance, represents a distinct management policy. This matter is taken up further.

CONCEPTUAL PERSPECTIVE: THE GIFT RELATIONSHIP AND LEGITIMATION

This article examines the introduction and implementation of the new costing technology, ABC, both from the perspective of the changes in the organization itself and in the context of the gift relationship as the fundamental characteristic of the health care organization studied. The importing of new accounting technologies from the private sector to the health care setting can carry two logics at the same time: the means-end logic which is at the basis of the rhetoric of efficiency and also a logic of legitimacy (Carruthers, 1995). Indeed, it has been suggested that institutional legitimacy reasons for actions within organizations may masquerade as 'technical' changes in organizations (Powell, 1991).

The specific focus of this article is an entity which makes health care products from blood transfusion services. For reasons of anonymity we call this organization HCP. The blood transfusion services have a number of discrete functions to fulfil their role as an essential component of the health service. First, there is the collection of blood from blood donors. Second, from blood collected, the basic unit of blood is made into a number of blood products, some of which may be specific to the attributes of particular donors (for the development of antibodies); in addition to antibodies, there are factors for coagulation and reagents for blood grouping,

haematology. In essence, there is a complex process from initial collection of the blood donation through processing and testing to these final products.

However, at the heart of the U.K. blood transfusion service there is the concept of the 'gift relationship' (Titmuss, 1970). While the gift relationship has been subject to scrutiny in non-market economies since the seminal work by Mauss (1954) in remote Polynesian societies, the nature of the gift relationship within blood donation is unique. This characteristic is one of Brunsson and Sahlin-Andersson's (2000) prerequisites for the construction of the complete organization: a special identity makes autonomy possible and desirable. As Titmuss (1970, p. 122) describes it, the gift of blood in the U.K. is unique because the recipient is not known to the donor; the donors are screened on rational not cultural grounds; there is no certainty of reciprocity for the donor; there are none of the penalties of shame, remorse or guilt associated with not giving in primitive societies; there is no monetary return to the donor of blood; the gift is perishable and the donor and receiver have no say in when the gift is used and there is no permanent loss to the donor whose body quickly replaces the donated blood and, finally, to the receiver, the gift of blood may mean life itself. These distinctive aspects of the HCP organization infuse it with value (Christensen and Molin, 1995).

All of the above circumstances serve to make blood transfusion a very distinctive service, one in which the prime source material is given as an act of altruism. There are other models, in other countries, which have their proponents, notably the market model in which donors receive payment for blood donated, and there is no gift relationship (Stewart, 1992). In the U.K., the continued voluntary donations, in conditions of anonymity, bereft of the guilt and reciprocity considerations of less advanced societies (Berking, 1999), places blood transfusion in a special situation. The gift relationship can be seen as casting a long shadow over the nature of the organization. In particular, given the nature of the exchange, there are aspects of this activity which may be regarded as falling within Power and Laughlin's (1992) view of the clinical domain as 'sacred'. The focus on ABC as a modern costing technology may be seen as opening up to the possibility of accounting information shaping the organization: defining key elements of what this organization is, what it does and how its priorities may be developed. This is a process of 'accountingization' which may be a corrosive influence in the life of an organization founded on the gift relationship. This perspective presumes that the new ABC-type information permeates the organization and that managers act upon it. This contrasts with the possibility in the earlier discussion of ABC that this technology may be adopted as part of the social construction of the organization, as the portrayal of the organization as 'modern' and, thereby, legitimate. This tension is explored further in the case study.

While the technologies used by organizations may be important for legitimization, so may organizational forms be demonstrative of legitimacy (Christensen and Molin, 1995). Indeed, from the perspective of organizations seeking legitimacy within the public sector, Brunsson (1994) has observed the phenomenon whereby organizations, which may have been regarded as political institutions, started to take on the trappings of commercial companies, a process which he labelled 'company-ization'.

This has overtones of the process of mimicry of the private sector by the public sector (Meyer and Rowan, 1977; Di Maggio and Powell, 1983) in the pursuit of legitimation, often in the face of uncertainty. By seeking to enter the organizational field of 'companies' or by being seen to be a part of this field, the HCP becomes exposed to pressures to adopt patterns of behaviour to achieve legitimacy (DiMaggio and Powell, 1983).

However, Brunsson goes further: Political organizations revolve around 'talks' and the company is more about 'action'. The implication of regarding itself as a company means that the political organization starts to assume the trappings of the commercial organization: For example, it regards the people in its environment as customers. The recognition of these differing perspectives shapes the organization in new ways. Brunsson and Sahlin-Andersson (2000) extend this perspective of legitimization by company-ization by examining how public sector organizations, as socially constructed phenomena, are being transformed into more 'complete organizations'. They explain this process as follows:

traditional public sector services in many countries have lacked some of the key aspects of organization. They can be described, at the most, as conspicuously 'incomplete' organizations. When existing services have been compared with the organization concept, their incompleteness in organizational terms has become obvious, and they have seemed to call for reforms to render them—in this sense—more complete. (p. 122)

In Brunsson and Sahlin-Andersson's view, for modernizers who construct organizations, the portrayal of the 'real' in complete organizations entails a high degree of identity, hierarchy and rationality. But much of this relates to organizations focusing on window-dressing, on portrayal rather than action (Mouritsen and Skaerbeek, 1995). These dimensions are identified, below, in the discussion of this part of the U.K.'s NHS move to become a 'complete organization'.

RESEARCH CONTEXT

The research approach in this study reflects the continuing advocacy of carrying out research within organizations to explore management accounting. Since Kaplan's (1986) call for case study research in organizations to better understand management accounting practice, the field study approach has been endorsed because of the richness of the data obtained (Ahrens and Dent, 1998) and the need to gain understanding of the broader context of management accounting practices (Whitley, 1999).

The HCP's major activities are the collection and testing of blood and the manufacture of products for clinical purposes. The HCP calls its core business the blood supply chain. The description of 'supply chain' for the collection of blood donations is a clear example of the language of business being adopted as an element of the portrayal of the HCP as a 'complete organization'. This is an example of the evolution of organizational language in a manner which uses vocabularies to present a picture of prudence, of rationality and of legitimation (Meyer and Rowan, 1977).

The HCP's supply chain is divided into four phases: collection, processing and testing, stock management, and distribution. The first phase (blood collection) is

based in five different sites. Recently the HCP tried to increase donations following lifestyle changes; for example, offering more opening hours and better accessibility to mobile donating centres (MDC). The second phase (blood processing and testing) is performed in centres situated in two major U.K. cities. Stock management has facilitated the use of available supplies and ensures blood continues to be distributed according to need throughout the country. The systems were devised to monitor overall stock levels on a daily basis and facilitate longer term strategic planning. Finally the transport staff, besides supporting blood collection activities, provide an integrated system for delivery of products to hospitals. A fifth phase can be included in this first process: the clinical service. It is a support function performed locally by consultants providing specialist transfusion advice and services to hospitals.

In addition to the supply chain, the HCP has two manufacturing plants (named here MP1 and MP2). The first manufacturing plant (MP1) is the division of the HCP responsible for providing hospitals with plasma products. This plant manufactures the blood into four core products as a basis for a range which includes hundreds of antibody products, albumin and coagulation factors. A further process entails the development and manufacture of products (MP2) for use in clinical diagnosis, bioscience research and further manufacturing. The product range includes reagents for blood grouping, haematology, clinical chemistry and immunochemistry. Furthermore, HCP offers contract services to the bioscience industry and manufactures products for major global players in the medical device, diagnostic, biotechnology and pharmaceutical sectors.

The current case study enhances the prospect of studying the context in which management accounting is practised and doing so by tracing practices over time (Yin, 1984; Bryman, 1989). The particular approach adopted here recognises the need to stay in touch and to revisit case study settings to gain a fuller understanding of what has happened (Bryman, 1989; Gallmeier, 1991). As Bryman (1989, p. 242) observes:

When research is based on detailed case studies there are often clear benefits associated with either an extended stay *or a return to the organization* in question. One of the strengths of qualitative research which is based on detailed case studies is that it is able to capture processes over time. If the sojourn is too short, an uncharacteristic state may be observed. (emphasis added)

In this case one of the research team has observed the organization over a number of years, noting significant accounting changes.

In terms of the actual investigation, a strength of case studies is the capability of using a variety of research techniques to obtain data required (Yin, 1984; Bryman, 1989). The research team used the following data sources: (a) documentation (examples of internal reports, costing studies), (b) archival records (organizational charts, internal evaluations), (c) observations of software demonstrations of activity based costing, and (d) interviews and key informants. There was limited time for the observation of ABC use in this study. But observation can be problematic, in terms of Hawthorne effects and in validating findings (Atkinson

and Shaffir, 1998). This study therefore falls within 'type 3' of Bryman's (1989) classifications of qualitative research: The principal sources of evidence are interviews and documents. To the extent that there is observation in this study, it is non-participant and on the periphery of the action (Bryman, 1989, p. 153). As such, this use of observation is essentially supplementary, to augment data from interviews and documentary materials. Its use has included observation of activities of everyday organizational life before and after interviews or at breaks (meal times, coffee breaks). Crompton and Jones (1988, p. 21) stress the importance of drawing on such insights in undertaking case study investigations: 'You have to regard all the time you spend inside the organization as a part of research. Those who employ participant observation techniques will already recognize this, but it is more important to stress that it holds just as strongly for those using more formal techniques.'

In interviews, the study drew upon the experience of a number of key informants both currently and previously employed in the organization. Most of these key interviewees were interviewed on more than one occasion. The key informants are depicted here as the Initiator (the director of corporate strategy, who was the first senior manager to initiate developments in costing, twenty years previously), the Architect (the director of finance, who had made the first attempt to implement ABC but this failed to reach fruition), the Chief Implementer (who has been charged, with his team of implementers, with delivering an operational ABC system for this organization) and the Recipients (who include the director of a major manufacturing facility at HCP who has been interested in receiving refined costing information for the past two decades). In addition, there is a whole range of other lesser actors on the scene (see Table 1) and those who previously inhabited the scene who have been interviewed as part of this investigation.

These informants were located at different levels within the organization and within different functions to maximize the investigators' understanding of the processes of change (Whyte, 1984; Jones, 1996). This method requires a flexibility of approach in interviewing, with interviews being long or short, with the need for supplementary discussions to resolve queries and explore issues further (Bresnen, 1988). For example, the Chief Implementer was interviewed on five occasions. Also, a more open-ended approach, where necessary, allowed informants to comment more fully on the cultural information on the organization which gave a wider understanding of the context of the accounting changes (Christensen, 1988).

RESULTS: IDEAS AND ACTIONS

An appreciation of the general context in which the HCP is situated is fundamental to understanding the environment and the challenges for the ABC project. The HCP came into existence as a voluntary body. As part of the nationalization of the health service in 1947 it became absorbed into the then new National Health Service. However, it retained significant operational autonomy in this role as an adjunct to the hospital service. Its internal structures and organization went largely unchanged for decades until the pressures discussed below led to the desire of its

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TABLE 1
THE KEY INFORMANTS

	Wider role	Designation
1	Implementer 1	Lead finance MP1
2	Recipient 1	Director of MP1
3	Implementer 2	Lead finance manager MP2
4	Recipient 2	Director of supply chain
5	Implementer 3	Lead finance manager clinical services
6	Architect	Director of finance
7	Chief Implementer	Financial controller
8	Recipient 4	Business manager
9	Recipient 5	Laboratory user
10	Recipient 6	Director of MP2
11	Advocate	Service director
12	Initiator	Director of strategy
13	Recipient 7	Operational manager
14	Interpreter	Business manager
15	Recipient 8	Clinical director blood transfusion centre
16	Provider	Deputy finance director
17	Implementer 4	Management accountant

senior management to portray HCP as a 'complete organization'. The events which shaped the pressures for change at HCP are largely externally driven, although the specific locus of ABC as a mechanism for managers is attributable to the presence of a champion for ABC within the staff. These aspects of the change process at HCP are elaborated upon below.

The Changing Environment

During the 1980s and the '90s a slow process of 'erosion' (as described by the Initiator) affected HCP, which caused both greater difficulties in services management and a change in the 'gift chain' with donors and patients. The major event that dramatically changed the blood transfusion services in developed countries was the discovery of AIDS, as the following comment demonstrates:

I would say that for our service, but probably for blood transfusion services in most of the developed countries, what was the real watershed, it might be the *extinction event*, that actually was AIDS, the recognition of AIDS as disease, the discovery of the virus and the most devastating thing of all was the realization that patients who were receiving long term treatment with blood, with haemophilia for example, and that many of them were in some clinics where all of them have actually been infected with HIV, before the first whisper of a problem; this was actually something that the damage had been done before anybody knew about it. I think that's a very fundamental crack in the foundation of confidence in our services. (Initiator)

HEALTH CARE COSTING INNOVATIONS AND LEGITIMATION

The discovery of AIDS in 1981 suddenly put blood transfusion services at the centre of public examination, causing in some cases a widespread impact on the entire national health care services. Rosenbrock *et al.* (2000) refer to this first period (1981–6) as the

emergence of exceptionalism in which governments moved in uncertainty, trying to develop policies to address public fear and related political tensions. Everyone, researchers, doctors, politicians and patients discovered that blood transfusions could transfer a virus against which the available treatments were useless. The general certainty given by effective antibiotics that the age of infectious diseases had come to an end in wealthy, industrialized countries suddenly disappeared.

(See also Ballard, 1992; Kirp and Bayer, 1992.) This dramatic impact was experienced internationally (Feldman and Bayer, 1999) triggering a high degree of political readiness to spend money to rectify this damaging situation. This fundamental event affected perceptions of blood transfusion services both at the individual and at the national level.

The need for higher safety measures and the consequent increasing of costs, together with continuous budget reductions, ended in a major reorganization at HCP in the late '90s. The management board decided to restructure the organization, going from the initial five nearly independent units to the centralization of all support and analysis services at the headquarters (in this case the centralization was only partial, moving from the five initial local sites to the current two main centres). This accords with Brunsson and Sahlin-Andersson's (2000, p. 726) view that one of the first acts of a public sector organization seeking to construct itself as a complete organization is the establishment of an authoritative centre. The consequences of the restructuring were a massive reduction of the overall staff (one-third) and the better use of resources, achieving economies of scale both in the support services and the testing phase, which has become increasingly complex and expensive. Two processes of HCP have remained decentralized in the five directorates: the blood collection and the clinical service.

At the end of the '90s another crucial event caused great concern and changes in HCP: the appearance of bovine spongiform encephalopathy (BSE) and its human variant Creutzfeldt-Jakob disease (vCJD), first discovered in 1996 in the U.K. There is good scientific evidence that vCJD in humans is closely related to BSE. Though so far there is no evidence that vCJD has been transmitted by blood transfusion, a number of features of vCJD suggest this possibility. It is not known whether vCJD will prove to be transmissible between humans by blood products but the risk cannot be excluded.

The existence of vCJD deeply affected the running of HCP. Since 1998 it has been forbidden to use U.K. plasma and consequently it has had to be bought in from other countries. A previously free raw material has become regulated by market rules.

I think the major life change for us was in 1998 when the decision was made to stop using U.K. plasma because of the concern with BSE and vCJD and we had to go and buy our raw material—the major raw material; we had to learn what was going on in the wider world and we became much more aware of what our competitors were doing. And that

was also a question for our economic performance. Suddenly we had to find cash to go and buy these materials. (Business manager of MP1)

The ABC Story: A Management Solution

Within this context ABC has been a leitmotif for management change in the last two decades in HCP. The interest in a sharper costing methodology started in the 1980s but it was in the early 1990s that the HCP management board started to develop an ABC model. The first attempt at an application of ABC in HCP was in 1993. The awareness of the limited use of the low level accounting data in the organization drove the Architect to propose the introduction of a new approach which was more management oriented: ABC was considered apposite. The aim of the ABC project was to join accounting information with statistical data, which was to be translated into the language of managers using 'activities'. But in 1993 contingent problems stopped the project in the concept phase. A lack of resources and a lack of top management commitment halted their first phase of ABC at HCP. Only in 1996–97 did the ABC project go ahead and a management accountant was employed for its development in one of the two manufacturing plants. The ABC design was supported by a consultant, who advised the project team, in an attempt to design cost information for management and not for use, just by accountants, as the following comment from the Architect shows:

We asked for the help of [...], he was of terrific help, to educate us and the team because we drew a team of managers from across the organization who represented all the functions that we wanted the costing system to cover. Because we wanted this driven by the user and not another system an accountant devised, because we have plenty of them.

A second step was made but the urgent reorganization of the '90s stopped the ABC project again at the design phase; at that time the ABC model was built on high level activities, waiting for an appropriate software package choice before further development. HCP abandoned ABC temporarily, having realized that the organization, as a whole, was not efficiently structured and they were not able to achieve economies of scale in manufacturing and testing blood. Brunsson and Sahlin-Andersson (2000, p. 727) have described this as the *construction of rationality*. Top management realized that the organizational structure was not 'intentional' and not appropriate to the changed context. This process of company-ization (Brunsson, 1994) is the result on the one hand of the changes on the supply side, but on the other hand it was seen as the answer to the increased turbulence of markets, especially for segments providing products outside NHS. The need to remain competitive and to capture new customers is suggested by the director of MP2 as fundamental, as the following comment shows: 'we operate in a global market. Twelve years ago we recognized the need for change—we had to change all the time to remain viable. We had to recognize that the market was changing and it continues to do so' (MP2 Director). With this reshaped organization, an agreed decision of the management board led to the pursuit of the implementation and development of ABC, with the aim of getting a better understanding of HCP costs and building a useful tool for management decision making, as the Architect stated:

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We trade worldwide, we do have contracts all over the world and we need better costing for that. So the primary driver for ABC was not needing a billing system, nor needing a pricing mechanism, it was entirely management information driven, which was nice, because we could design it as management tool and not as a short term pricing mechanism that never actually becomes a management tool. We compare what we do with other colleagues elsewhere who use it as a pricing tool and I don't think they are going much beyond that.

Despite this shared vision, the claims made for ABC were revealed to be multi-faceted, in line with the perspectives and the emphases given by different interviewees. Notwithstanding these differences, a common belief was perceived during the field study: Management perceived a need for a costing methodology and they chose ABC.

It is interesting to note that most of the interviewees were not able to justify the choice of this particular costing technology, whose selection seems to be more related to the presence of a champion of ABC in the organization and management's desire to use 'modern' techniques than to a real evaluation of its benefits and its costs. For example, the clinical director of a blood transfusion centre said that the reasons for choosing ABC, rather than another costing methodology, had never been formalized. He described the adoption of ABC as a 'blind belief' in this modern technology.

The lack of a formal cost benefit analysis of the policy to adopt ABC was not regarded by those interviewed as a problem. They considered ABC to be the right answer to external pressures for competing in a global market and for reducing budget expenditure. The reduced budget was an important trigger for looking outside the NHS, searching for new markets and possibilities to increase income. HCP has pursued this road in recent years, but being a public organization constrains this policy. The twin aims of efficiency and cost control consequently became complementary elements of HCP strategy, as the following comment from the Chief Implementer shows:

The motivation for that was our annual budget getting cut every year so the only way we can balance the books was *to try to get income in the door or to reduce cost*. Trying to get more income in the door over the last five years we were very successful by doing that, particularly working within context of public sector, *our biggest problem at the moment is not we don't have customers* if we had the commercial freedom to do it we could maybe triple the business overnight.

The comment highlights a contrast within the organization which derives from being between the public and the private sector. The process of company-ization emphasized by the awareness of being less 'protected' by the government, led managers to become more conscious of the organization, as this comment shows:

whereas in 90s-80s there was a sort of immortality about what we did, what the HCP does and we felt the need to be cost conscious but then at the end of the day the politicians would give us the money we required. There is a culture developing now, particularly in this part of the service, which is much more about continuing in the long term to deliver a good economic performance, we have become much more self-determined in how we run the business and when you make that sort of intellectual leap you have to have a good understanding of your costs. (Director of MP2)

These key informants put great emphasis on the need to sustain new, market oriented businesses, depicting them as the future of HCP. By contrast, the director of strategy affirmed the fundamental urgency of adopting a costing methodology in the traditional blood supply chain, for cost saving and not as a marketing strategy. The appearance of AIDS and vCJD dramatically increased the cost of processing and testing blood:

We now have to do special filtration to every single unit, which has a substantial cost for disposables, probably at least double costs for disposables, and substantially increases the labour cost, and the substantial quantity of overhead. Whereas until ten years ago we collected 500 ml of blood we could make three materials: red cells, platelets, and most of the plasma collected was fractionated into products. In the last three years we are no longer permitted to use that plasma. We have to be insulated, this is because of BSE, we have to import plasma from either the U.S. or other European countries that claim not to have BSE. If you like we went from a product whose value had three elements, we had lost one of them and we are seeking to obtain it at prices which are governed by the international price of plasma. Not surprisingly there is an international shortage of plasma and so basically they can charge whatever they want. (Initiator)

ABC Implementation: Try and Try Again

The perspectives expressed above underline the need for the ABC project which was felt to be more than necessary, it was urgent. The Architect, with the management board agreement, enrolled the Chief Implementer and the ABC project was extended to the whole organization. Five different project teams were built up for implementing the ABC technique throughout the organization: blood supply chain, first manufacturing plant (MP1), manufacturing plant for diagnostic services (MP2), clinical services, support services. However, there were aspects of the manner, timing and resources given to implementation which raise questions about senior management's commitment to a full-scale operational ABC system. This ABC implementation was carried out without the help of consultants; an external organization was enrolled only to provide software and some training courses for the implementers.

The first stage of the implementation was the identification of activities for each area, in which teams encountered different problems. First, they were not provided with sufficient training on the ABC conceptual framework. The move from the *generality* of what ABC purported to be to the *specific* requirements of this organization created difficulties for implementers without previous exposure to ABC. The problem was most evident in the clinical services where the team leader collected information from five different sites. He asked recipients to write down a map of activities and drivers but his incomplete knowledge of ABC and the culture of hospital clinicians not being prepared to 'talk to accounting people' (see also Jones, 1999) generated many problems.

At the beginning we didn't understand what they wanted from us, we didn't know how detailed we had to be and the meaning of drivers, it took several months to get into the job. You have to consider that we have done it in addition to our routine tasks. (Clinical Service Recipient)

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Second, they had to upgrade the information collected in the ABC software, but the training was provided four months after the beginning of the project. Implementers lost a lot of time in understanding where and how to insert information.

As part of my training as an accountant I learnt some of the theory, but not very detailed and one difficulty was for example we are using software but we didn't have formal training since the beginning of August, which would have been useful to have had earlier. The fact that I didn't have training slowed down all the process of inserting information. (Implementer at MP2)

The lack of background knowledge on, and the specific requirements of, ABC at HCP and the non-alignment of training slowed down the implementation process and created confusion. As the Initiator stated, the implementers were not prepared for such a task, they had inadequate preparation and, moreover, they had to follow the ABC projects concurrently with their routine tasks, as the following comment illustrates:

They worked like hell to set it up and my sense was that the vast majority of the efforts in establishing that bit of ABC for the rest of the operational staff was entirely an addition to their existing job, and the finance people had an idea of the concept but actually they couldn't operationalize it: (a) they weren't prepared to spend the time, (b) they didn't have sufficient understanding of the processes. They were not prepared to get the understanding of the process that would allow them to do a significant part of basic data definition, without which things are guaranteed to give you the wrong financial information.

As the comment shows, another critical aspect of the implementation process was getting an understanding of the processes, because the teams were constituted by finance people, with no experience of the field and technical preparation. This experience underpins the complexity of the ABC implementation process, especially in complex organizations such as health care. ABC phases, especially the inventory of activities and the ascertainment of cost drivers (Innes and Mitchell, 1995), require a process knowledge that takes activity-based technology away from accounting ownership.

While this difficulty can be seen as common to all the teams, specific barriers were encountered in the different divisions of HCP. In clinical services the major problem was the initial resistance of clinicians. Such rejection on cultural grounds is suggested to be one of the most important reasons for ABC implementation failure (Roberts and Silvester, 1996). This finding resonates with the general finding that clinicians are reluctant to adopt, or are resistant to, accounting and budgeting information (Preston *et al.*, 1992; Jones and Dewing, 1997; Lapsley, 2001a). The particular field in which this issue was raised cannot be seen as chance: Two reasons can explain the differences in reaction by the users. First of all the cultural background. After the reorganization, the other four areas became more centrally controlled by HCP managers, but by contrast the clinical services were decentralized in the major hospitals and still remained under the responsibility of clinicians, who are less used to dealing with accounting, costing terminology and whose work is basically driven by the patients' interest. Secondly, the activities involved in the other four processes are indeed closer to a private sector operation. However, the

clinical services, in a virtual continuum, can be seen as the closest to the essence of public sector organizations. These issues are reflected in the comments of the Clinical Service Implementer (who encountered behavioural difficulties of acceptance) and DS Implementer (who did not encounter behavioural difficulties):

The major challenge is culture, their [clinicians] attitude to their cases is, well, 'I have to spend it is for the benefit of my patients', and I have extreme difficulties in arguing against that, because there is a patient benefit. At the end of the day somebody is going to have a different method of treatment, improved method of treatment, I find it very difficult argue against it but I've got to try and argue and say how are we going to pay for it. (Clinical Services Implementer)

The difficulties I had, not from the people, managers were totally behind it to realize that in their daily activity this information was extremely important. (Implementer at MP2)

Another operational difficulty was the identification of cost pools. The implementation teams approached the development of the ABC model differently, experiencing various problems in data aggregation. For example, the MP1 Implementer started the whole design from the existing cost centres, not from an inventory of activities. This reverse approach proved to be critical at the moment of linking costs to activities and created delays in the whole project. The other services approached the process in a traditional way, which helped to facilitate pooling the costs in accordance with the activities that cause them.

Though the diagnostic services seemed to be efficient and coherent in approaching their ABC design, some problems affected the implementation in this area too, in particular the collection of cost driver information. While the financial information was contained in the financial ledger, the non-financial information was collected from old, non-homogeneous reports, as the following comment shows:

historically within diagnostic services the costing information was very old, so there wasn't really reliable information in there. I have used some reports but for example the unit of measurement is not reported near the number; so that measure might be in litres or might be in millilitres. It was very difficult for me to know that one was litres and the other one millilitres. It was resolved by managers who know these things, by asking questions and by making mistakes. (Implementer at MP2)

Finally, a major operational problem during implementation was the incompatibility of the software with the two existing information systems that manage the financial information and the manufacturing cycle data. The situation forced the Diagnostic Services Implementer at MP2 to transfer the information among the systems manually. The non-sustainability of such a process has been recognized by all the interviewees but no solutions have yet been clearly defined. All of this undermines HCP's stated aim of having an operational ABC system.

ABC and the Complete Organization

The HCP can be set on the blurred and ambiguous boundary between public and private organizations (Metcalfe, 1993), with its divisions shifted differentially towards public or private. This heterogeneity entailed different needs and uses of

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ABC, though under the same urgency of introducing a more precise costing technology. The two manufacturing plants share a major company-ization process (Brunsson, 1994) assuming many features of private companies derived from the need to compete in the outside market. The operational management is expected by top management to see the introduction of ABC as an essential tool for a better understanding of the cost of products and using it both for pricing policy and product rationalization, as the following comments show:

it was important we developed a costing methodology that would fit into pricing, and the pricing is important if we want any contracts outside the NHS because we were subsidising some activities and not fully recovering the cost. It was a danger that we weren't doing that because we were charging the marginal cost... another benefit of ABC is product rationalization, because at the moment we've got more than two hundred products, we are not Jack of all trades, it is not feasible. So we have been using the costing methodology developed in diagnostic services to look at profitability and see how we can rationalize their products. (Chief Implementer)

The goals of ABC suggested by the Chief Implementer were confirmed by documentation and other interviewees within the two manufacturing plants, but these objectives were depicted as potential and not so far realized. The ABC output, to date, is not considered reliable enough to inform management decisions, as this comment shows:

At the moment I don't think managers want to react to the information, because some data are missing. We need to develop and update it. But it more or less indicates which products are loss-making, but we need to validate the model. At the moment because it has not been updated and validated it gives the manager an excuse not to act upon it. (Implementer at Diagnostic Services, MP1)

The dynamic process of company-ization can be clearly seen in the MP1, in which previous attempts at introducing ABC were carried out. In particular, the way in which the first introduction was endorsed in one of the manufacturing plants clearly shows the process of picking out attractive individual bits from different institutions (Brunsson, 1994). A recipient observed: 'we were doing ABC because the Architect and some managers knew ABC, nobody knew what we were talking about but we knew we were enthusiastic about it. We didn't know what we wanted but we knew that we wanted it.'

The above comment portrays the adoption of ABC as an 'act of faith' (as one of the interviewees suggested) instead of the image of a conscious introduction of a technology suited for their purposes. The abortive failure and the consequent reorganization shape a situation described by Brunsson and Sahlin-Andersson (2000) in which the 'attraction' by a management technique can lead to looking at the organization and finding out its inappropriateness:

Policy makers or local managers may have been attracted by certain popular ideas about leadership or management accounting techniques, and later have found out that these ideas or techniques actually presuppose the existence of a complete organization. In arguing for the favoured techniques, they have then found it necessary to claim organizational status, and the concept of the organization has then inspired further organizational reforms.

The management have now been making a more conscious attempt at introducing ABC in the reshaped organization, nevertheless a major degree of resistance has slowed its implementation in the areas most affected by the reorganization: blood collection and the clinical services. The major resistance is reflected in the attitude towards the introduction of ABC, a technology which appeared to the recipients inappropriate for an organization not driven by profit but by the creation and support of values (Brunsson, 1994). There are differences within the constituent elements of the HCP which reveal the loosely coupled nature (Weick, 2001) of the organization and the pressures of the 'near-market' part of the HCP, as the following comment from a Recipient, the Director of MP1, illustrates:

Except for ourselves and diagnostic services [MP2], the rest of the service is driven . . . if you ask the manager of the clinical directorates or the supply chain what their priorities are on Monday morning they won't be economic performance, it is about looking at the patients, collecting enough blood, satisfying the minister's requirements on hepatitis C, there tend to be more political issues, but there is an emerging political concern about the cost of blood that is going up and up. On the other hand in the manufacturing bits of the organization (actually clinical diagnostics is just as aware if not more so), we actually have to interface with the commercial industrial part of the world as well. We sit between a sort of public sector and ministerial stuff and have the heartache of actually delivering and dealing with economic performance. (Recipient 1, MP1)

Nevertheless as the Recipient acknowledges, it is the battle for economic performance which is important, as the HCP seeks to transform itself into a 'complete organization' in the search for legitimacy.

Ultimately, however, the accountants acknowledge that, after a decade, only modest progress has been made in devising an operational ABC system. The management accountant summed up progress on ABC as follows:

Things go slowly—we are not there yet . . . the managers on the ground are not using ABC, because ABC reports are not given to them routinely . . . The ABC models are used on an *ad hoc* basis, if at all. We are not certain of when we will go to monthly reports. This is more of a long term plan. Then every month there is something changing. ABC information has frailties. A lot of our work is still a first stab. It doesn't seem quite right. But we should have a better idea of outcomes and inputs. There is a bit of 'tweaking' going on.

The management accountant saw ABC as an *ad hoc* costing system which would provide back-up to the present budgetary system and an input into strategy development. However, the management accountant acknowledged that the ABC system was not operational and that to date there was no definite plan as to when ABC would become operational, or for a full evaluation of the work done. The management accountant suggested that those areas of the HCP which had found ABC to be of some use should be able to continue with it, but that it was not compulsory. Interestingly, at this time, in terms of imperatives, the director of finance had an action list of important tasks listed on a whiteboard. There was no mention of ABC. This is an example of an organization paying more attention to the appearance of what they do than to the actions themselves (Mouritsen, 1994).

CONCLUSION: FROM GIFT RELATIONSHIP
TO COMPLETE ORGANIZATION

This research has examined the implementation of ABC in a health care setting. This implementation process has taken a decade. But ABC is not yet operational. These findings confirm Suchman's (1995) observation that early adopters of innovation reside at or near the locus of theorization and adopt innovations for instrumental reasons, but late adopters (such as HCP) are remote (as HCP is from the private sector origins of ABC), and where the innovation is adopted for reasons of meaning and legitimation. Nevertheless, as noted in passing, despite the technical difficulties of implementation in a complex multi-product public service organization, certain senior managers support, or lay claim to, ABC as one of their tools. This phenomenon can be viewed in the light of significant disruption in the external environment of this organization which has shaped the manner in which it has sought to project itself as modern, as legitimate—as a 'complete organization'. Given the change of direction of HCP, both in terms of its purchase of plasma in commercial markets, and its active pursuit of lucrative contracts to ease the constraints of being funded as a public sector agency, there is a very strong sense that the transformation of this organization is company-ization, a move to the complete organization. This outcome is intensified by medical innovation. Specifically, the imminent advent of commercial products which are given to patients instead of, and are as effective as, human plasma in hospitals. With such innovations and the dwindling number of targeted donors (for reasons of safety, risks and the need for specific antibodies), the very core—the gift relationship—which has sustained this institution for decades is threatened, and the pressures for the HCP to become a 'complete' organization become inevitable. In all of this, the adoption of ABC as a badge of efficiency is questionable. This is in the face of uncertainties in the environment over markets for its products, its relationship with donors and with funding agencies. At best ABC is part of an exercise in legitimacy.

This study has shown the merits of case study research which gathers findings in depth and which reveals a richer story than survey methods which would have reported an ABC implementation. Also, in examining the portability of accounting technologies for management which originate in the private sector, the findings of this work support the view that the underlying complexity of public sector organizations undermines the simple transfer of ideas and practices from private to public sector. This study also points to the careful examination of language in change situations. The adoption of business language may not serve an instrumental purpose: The adopting organization may be seeking to portray itself as 'different' (especially from its public sector origins) and may use the vocabularies of modern accounting and business practice in the private sector to paint a particular picture of itself. This finding on language is intensified by the findings on, and need to study, the impact of the external environment on organizational practices. In this study, mimicry of what was considered best private sector practice and the need to portray the organization as 'modern' and 'complete' to legitimate its activities were important elements of the adoption of ABC. This research underlines the need to look at

interdependencies in studying accounting changes in organizations in general but in public sector organizations in particular. The interweaving of instrumental and symbolic logics for the adoption of specific technologies is an important element of understanding the nature of organizational changes in accounting practices.

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Stock Price Response to News of Securities Fraud Litigation: An Analysis of Sequential and Conditional Information

This study examines investor response to three events that help define a federal class action securities lawsuit, specifically, the announcement that names an issuer as a defendant in the lawsuit (at the class action filing date), the disclosure or accounting restatement that 'corrects' the information deficiency (at the end of the class period), and the date at which the fraud on the market allegedly begins (at the beginning of the class period). We document a significant and predictable stock price response at each of these three events. Our tests also indicate that the market interprets these events not in isolation but as sequential and conditional events. Investor response differs on the basis of the characteristics of the issuer, the allegations in the complaint, and the outcome of the litigation. These results and the fact that we observe no systematic price momentum in investor response beyond the announcement dates imply that the market is reasonably efficient with respect to information about securities fraud litigation. Our results are robust to alternative definitions and procedures, and are based on a proprietary database that includes almost all federal securities class action lawsuits since 1990.

Key words: Class action; Economic impact; Fraud, accounting; Litigation; Stock market.

INTRODUCTION

Federal class action securities fraud litigation is a common, controversial and complex event. From January 1990 through June 2003, more than 3,000 issuers have been named as defendants in these lawsuits.¹ While these include the celebrated cases of Enron, WorldCom, Tyco and other substantial frauds, most

¹ Based on data provided by Institutional Shareholder Services, Inc. See below for further details.

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other class action allegations receive less media attention and are predominantly the result of an accounting correction or an alleged violation of insider trading or other similar rules. The majority of these lawsuits also includes settlements for relatively small amounts. Buckberg *et al.* (2003), for example, report an average and median class action settlement of \$16.5 million and \$4.8 million, respectively. The largest settlement of these lawsuits occurred in 2000, when Cendant and its auditors agreed to pay in excess of \$3.1 billion.²

The controversy surrounding this litigation is bitter and well defined. Plaintiffs' attorneys often contend that securities fraud is rife among America's public companies and that private class action litigation is a necessary supplement to the Securities and Exchange Commission's anti-fraud enforcement program. Critics of the current regime do not deny the existence of fraud. Instead, they contend that the litigation process creates incentives to file frivolous or low-probability lawsuits that can be used to coerce settlements that are out of proportion to the merits of plaintiffs' claims.³

From an economic perspective, the complexity of class action securities fraud litigation centres on the fact that it is a compound phenomenon that involves several analytically distinct but sequential events. While informed investors assess litigation risk generally as part of their overall evaluation of a stock, the market's first clear indication of the potential for litigation occurs when an event causes a sharp drop in stock price. Plaintiffs' counsel analyse these price declines and events for a corrective disclosure and other facts that could support the filing of a complaint. If they believe that they have adequately identified such disclosure, a pattern of allegedly significant insider selling prior to the price decline, or other relevant facts, then they may file the lawsuit. The date of a corrective disclosure (the most recent disclosure if there are several) defines the end of the class period (ECP).

In some situations, the announcement that precipitates the price decline effectively reveals the elements of the cause of action that plaintiffs would have to allege in their complaint.⁴ A class action filing (CAF) can then be viewed as a foregone conclusion by the market, and a complaint is normally filed rapidly after

² In this record-breaking settlement, the issuer, Cendant Corporation, agreed to pay \$2.85 billion and Cendant's former auditors, Ernst & Young, agreed to pay \$335 million (Wise, 2000). However, this settlement amount could well be overshadowed by the Enron federal securities class action litigation, which seeks to impose liability on Enron's bankers, attorneys and accountants for their role in the bankruptcy (Toobin, 2002).

³ For a summary of the arguments for and against private securities litigation, see Conference Report (1995). See also Alexander (1991) for a study of whether merits matter in the settlement of these lawsuits.

⁴ For example, on 15 April 1998, Cendant Corporation reported that it had discovered potential accounting irregularities in certain former CUC International, Inc. business units and that it expected to restate net income and earnings per share for 1997 and possibly other previous periods. One day later, on 16 April, *Business Wire* reported that eight separate actions had been filed by plaintiffs' law firms.

the disclosure. A one-day stock price response would reflect the compound effect of the announcement and the class action lawsuit instigated by the announcement. In other situations, the filing occurs days, weeks, or even months after the price decline. In those circumstances, the CAF helps resolve the residual uncertainty that persisted since the ECP date (i.e., the market was unsure whether the litigation would ensue and the filing resolves that uncertainty).⁵

To date, the dominant focus of scholarly and regulatory attention has been on the stock price decline associated with a corrective disclosure that alerts the market to an alleged fraud. Several studies have documented that price declines that lead to securities litigation are well in excess of 10 per cent of market capitalization (e.g., Kellogg, 1984; Francis *et al.*, 1994). Several other studies have explored the characteristics of firms with high litigation risk and whether investors act as if they consider such characteristics at the time of a corrective disclosure (e.g., Jones and Weingram, 1996; Francis *et al.*, 1994).⁶ Although based on different factors, an underlying theme of these articles is that litigation-prone firms are identifiable. Informed investors therefore should anticipate the cost and probability of a class action lawsuit from the earlier disclosures. Still, the market cannot know that a lawsuit will be filed, when it will be filed, the magnitude of the alleged fraud, and what additional information will be revealed at the time of a filing.

In contrast, fewer studies have focused on the stock price effects of other events that help define the litigation process. These include the announcement that a company has been named as a defendant in a securities fraud class action lawsuit (the CAF date), the events or information used to allege when the fraud on the market begins (at the beginning of class period or BCP date), and those occurrences that reflect the disposition of the lawsuit, such as dismissal, settlement or judgment.⁷

For example, with respect to the CAF date, Bhagat *et al.* (1994) report a significant median announcement effect for a variety of lawsuit filings of -0.58 per cent (over two days). Feroz *et al.* (1991) report a mean excess return on days -1 and 0

⁵ While a significant price decline at the time of a corrective disclosure can increase the probability of a filing, not all significant price declines at the time of the correction disclosure date lead to class actions and not all class actions are preceded by significant price declines. See Jones and Weingram (1996) for an analysis of one-day price declines of 10 per cent or more that do not lead to litigation.

⁶ See also DeChow *et al.* (1996), who emphasize indicators of aggressive financial reporting. Related studies of litigation have considered the impact of early negative disclosure (Skinner, 1997); stock price performance (Beck and Bhagat, 1998, Bhagat *et al.*, 1998); and the number and tone of news releases prior to the class period (Kasznik and Lev, 1995). Other kinds of less direct indicators of litigation have also been examined, such as criticism by a financial commentator (Foster, 1979), interruption of a successive string of earnings increases (Barth *et al.*, 1999), disclosure of a negative earnings surprise for growth firms (Skinner and Sloan, 2000), and increased short interest trading (Griffin, 2003).

⁷ Almost all class actions are settled or dismissed. Buckberg *et al.* (2003) report that only 1 per cent end in judgments. While the primary focus of this study is on the CAF, ECP and BCP dates, we also document some preliminary results on the investor response to dismissal and settlement announcements. The sample sizes are considerably smaller, however.

of a corrective disclosure of -12.90 per cent and a subsequent change on days -1 and 0 of -7.50 per cent when the market learns of an SEC enforcement action in response to the earlier disclosure. Similarly, Dechow *et al.* (1996) report a mean excess return of -8.90 per cent on the day of a disclosure leading to an SEC enforcement action. These studies, however, do not focus exclusively on federal securities class actions and examine litigation that occurred mostly in the 1980s, prior to the passage of the Private Securities Litigation Reform Act of 1995 (hereafter, Reform Act).⁸ These and other studies of SEC actions (e.g., Beneish, 1999; Beasley *et al.*, 1999) also examine only more evident cases of violations of accounting and auditing principles rather than the full set of all alleged violations of the federal securities disclosure laws.⁹

Finally, Ferris and Pritchard (2001) document results for securities class actions filed after the Reform Act. They find a significant negative response at ECP date (average three-day excess return = -24.99 per cent) and CAF date (average three-day excess return = -3.47 per cent) but not at the date when investors learn that a motion to dismiss is granted or denied. They also test for but do not find an association between the market response on the ECP or CAF date and their proxy for the outcome of the litigation (the court grants or denies a dismissal). This result may be due to the small size of their sample (eighty-nine issuers).

In contrast, our study uses almost the entire population of approximately three thousand federal securities class actions from 1990 through 2002.¹⁰ Subject to data constraints, we are therefore able to conduct tests that are more powerful and less subject to sample selection bias than in the prior research.¹¹ The database also includes information on settlements and, as such, enables examination of an additional proxy for the outcome of the litigation. The analysis produces a different result from Ferris and Pritchard (2001) in this regard. The outcome of litigation is found to be partially anticipated by the stock market and that excess return at the ECP date is correlated with the outcome of the litigation.

⁸ The Private Securities Litigation Reform Act of 1995 (Pub. L. No. 104-67, 109 Stat. 737, 1995) amended the Securities Act of 1933 and Securities Exchange Act of 1934 and introduced several new provisions to curb abusive litigation (Title I), reduce coercive settlements (Title II) and changed certain auditor disclosures (Title III).

⁹ Several studies have also examined stock price reactions around the date of passage of the Reform Act, on 22 December 1995. For example, Johnson *et al.* (2000) find that while firms with high litigation risk responded positively to the passage of the Act, those with high litigation risk due to aggressive financial reporting were negatively affected. See also, Spiess and Tkac (1997).

¹⁰ Use is made of a proprietary database kindly made available by Institutional Shareholder Services, Inc. See also, 'The Sample and Data Characteristics' below.

¹¹ Focus on federal class action fraud litigation does not, however, eliminate the potential for selection bias, because we analyse and test hypotheses about events (e.g., events that signify the beginning and end of an alleged fraud) identified by a later event, namely the filing of a class action lawsuit. Also, the characteristics and consequences of private class action securities fraud litigation do not necessarily generalize to litigation by regulators, such as an SEC enforcement action. Our conclusion comments further on possible bias that might be introduced into the analysis as a result of our research design.

Finally, none of the studies thus far examines investor response at the BCP date, when it is alleged that the securities fraud begins (e.g., when misleading information is first disclosed to the market). This response can be important in that, if positive, it can add to the cost of litigation (as shareholder damages).¹² We expect a positive price response on this date for at least two reasons: first, that the market believes the false information and responds positively as intended; and second, as with the ECP date, plaintiffs' counsel may choose this date strategically so as to maximize damages.

This study attempts to address this imbalance in the literature. It presents a detailed empirical analysis of the stock market's response at the ECP, CAF and BCP dates using a comprehensive sample of federal class actions since 1990. As with earlier studies, we first examine the investor response on each date, assumed to be an independent event. A second series of tests recognizes that these occurrences are not independent but sequential events conditional not only on the earlier ones, but also on the outcome of the litigation and other factors posited to explain variation in investor response over time and across the sample.

Consistent with the earlier research, our results indicate that a CAF announcement has statistical significance that is separate and distinct from the ECP announcement that precipitates the litigation. This result is statistically more significant in later years (e.g., in the years following the Reform Act of 1995). Second, the mean excess return at the BCP date is positive and this response varies negatively with excess return at the ECP date. In other words, on average, the more positive the price response at BCP, the more negative the response at ECP. Third, the price response at the ECP and CAF dates varies positively with the size of the firm and negatively with the amount of settlement (for cases that are settled). Fourth, the price response is more negative for class actions with accounting allegations versus non-accounting allegations. Fifth, the price response at the ECP date varies negatively with the price response at the CAF date (for filings that arrive with at least some delay). This is consistent with the view that the more investors at the ECP date are able to anticipate partially the event of a filing the less the response at the CAF date and, vice-versa, the less a filing is anticipated at ECP the more the response at CAF (*cet. par.*).

Accordingly, this research contributes to the literature in two distinct ways. First, it shows that class action securities fraud litigation can impose significant costs on issuers at least at three distinct stages—the end of the class period, the beginning of the class period, and the class action filing date. These costs—as reflected in excess stock return—are immediate in that they are impounded in price within one

¹² The calculation of shareholder damages in a securities class action is the number of shares damaged times the damages per share, where damages per share is the maximum of zero or the difference between the price inflation at the time of purchase and the price inflation at the time of sale or zero if the stock is retained through the ECP. Thus, the higher the BCP price and/or the lower the ECP price, the greater the price inflation for someone who purchased early in the class period. Assuming other factors are unchanged, the greater the amount of inflation the greater the amount of investor damages.

or two days following each event. These costs, also, have a predictably disproportionate effect on smaller issuers and those whose litigation involves an accounting violation. In contrast, technology companies' responses are not reliably different from the others. Second, it shows that the three events are interrelated in that investors respond to the earlier event in ways that reflect attributes of the later event and/or the outcome of the litigation. For example, the response at ECP is more negative when the settlement is greater. Overall, these results are generally consistent with the view that the market is reasonably efficient with respect to information about securities fraud litigation.

HYPOTHESES

This section develops five general hypotheses about the investor response to securities class action litigation. Hypotheses are tested using an event-study approach based on daily excess stock return. This approach is widely applied in the analysis of financial events and is particularly suited to the sample for at least four reasons: (a) the litigation events are identifiable and reasonably similar in format, (b) the litigation information has the potential to change the distribution of stock return, (c) the events are broadly distributed over a ten-year study period (rather than clustered around a few dates), and (d) the events are largely driven by independent, company-specific information. We test the following hypotheses:

Hypothesis 1: The market reacts negatively at ECP date (H1a) and CAF date (H1b) and positively at BCP date (H1c). It is assumed that securities class action litigation anticipated at ECP date and known at CAF date imposes costs on a firm that can only reduce its market value. These costs include expected litigation, administrative and settlement costs, the opportunity cost of diverted management resources, and the potential loss of reputation and goodwill. An expected positive reaction at BCP date derives more specifically from the view that securities fraud, which is designed to inflate stock price, is alleged to have begun on this date. Plaintiffs' counsel also may choose the ECP and BCP dates strategically so as to maximize damages as part of the settlement process. This exacerbates the likelihood of observing a positive effect at BCP date and a negative effect at the ECP and CAF dates.¹³

Hypothesis 2: Securities fraud litigation carries a significant fixed cost for an issuer. Plaintiffs' counsel, for example, may seek a minimum expected settlement to cover their costs. It is hypothesized that the market response reflects this cost attribute and, as such, is more negative for smaller firms than larger firms at the ECP and CAF dates (H2a) and more positive for smaller firms at the BCP date (H2b). Rejection of this hypothesis could, however, also be consistent with other explanations. Firm size, for example, may be a proxy for the cost to investors of

¹³ See also note 12.

obtaining and processing information about litigation events to the extent that it is lower for larger than smaller firms.¹⁴

Hypothesis 3: Securities fraud litigation should be more costly at ECP date (H3a) and CAF date (H3b) for allegations of a failure of the accounting system (e.g., a restatement, an accounting irregularity) compared to non-accounting allegations (e.g., insider trading, breach of fiduciary duty).¹⁵ An admission that an issuer overstated earnings, for example, should not only be reasonably unambiguous as a corrective disclosure but also, to an investor, such news should have predictable valuation implications (since firm value is in part based on earnings). In contrast, the fact that insider trading or a breach of fiduciary duty may have occurred may be less indicative of fraud and, as such, should have less clear-cut implications for value. It has also been documented that settlements are higher for accounting than non-accounting allegations (Buckberg *et al.*, 2003). If investors anticipate these costs at ECP or CAF date, this too should help explain why the investor response should be greater for accounting than non-accounting allegations.

Hypothesis 4: This hypothesis predicts that investors respond to news at the BCP, ECP and CAF dates as sequential events in the litigation process. First, to the extent that investors anticipate the act of and costs associated with a class action filing, then the stronger the (negative) response on ECP date the weaker the (negative) response on CAF date and vice versa (H4a). We should therefore observe a negative (or non-positive) association between these responses. However, if the CAF date is very close to the ECP date, or even on the same day, the CAF and ECP response would reflect the same news and the relation would be positive. Therefore this hypothesis is tested for delayed filings only, defined as those where enough time has elapsed for the stock price to incorporate the momentum effects, if any, of the corrective disclosure at ECP. A five-day delay period is used. We also test this hypothesis based on a longer delay period, although a longer period increases the likelihood that investor response at CAF date will reflect new information unavailable at ECP date. Given market efficiency, the market response to this information should be uncorrelated with the response at ECP date. A longer delay period shifts the negative relation toward zero.

We also hypothesize a negative association between investor response at the ECP and BCP dates (H4b). As indicated earlier, this could occur because the greater the price inflation at the BCP the greater the price drop following disclosure of this inflation, and because plaintiffs' counsel may choose a BCP so as to maximize the drop in price (and plaintiffs' calculation of damages). However, if the fraud on the market takes place in several stages over the class period, this relation

¹⁴ Financial analyst coverage is also greater for larger issuers sued in a securities class action (e.g., Griffin and Grundfest, 2002). The financial press too appears to be more interested in larger firms and firms with a more complete information environment (Miller, 2003).

¹⁵ The Univariate Analyses section describes the procedures used to partition the sample into accounting allegation class actions and non-accounting allegation class actions.

would be biased to zero. The BCP date in this case only partially reveals the amount of price inflation.

Hypothesis 5: This hypothesis tests the proposition that investors in an efficient market are able to anticipate the outcome of the litigation process. At ECP date, rational investors should not only anticipate the event of a CAF (which we test as Hypothesis 4) but also subsequent events and costs such as dismissal and settlement. This hypothesis predicts that the price response at ECP date will be negatively associated with the amount of settlement (H5a) and positively associated with the court's decision to grant a dismissal (a unit dummy variable) (H5b). In other words, investors at ECP date should respond less negatively to dismissed cases, and more negatively the greater the amount of settlement.

THE SAMPLE AND DATA CHARACTERISTICS

The initial sample of 2,929 includes federal securities class action filing dates for the period from 1 January 1990 to 31 December 2002 from a database maintained by Institutional Shareholder Services, Inc.¹⁶ This database covers essentially the entire population of federal class action filings, as well as a substantial number of state filings, since the late 1980s.

Table 1 provides additional details of the sample. Panel A indicates that the distribution of federal class action filing dates is non-uniform over the week, with proportionately more filings on Fridays. This could affect the interpretation of our results as the distribution of stock return over weekdays generally is also non-uniform (e.g., French 1980; Gibbons and Hess, 1981).¹⁷ Panel B reports the mean and median length of the class period (based on 2,811 observations), calculated as ECP date minus BCP date. The overall mean (median) length is 411 (296) days. Panel B also shows that the average class period has declined since the passage of the Reform Act ($t = -5.582$). On the other hand, Panel C shows that the number of days between ECP and CAF date has increased ($t = 2.863$). While not tested, such increase in filing delay may derive from the additional burden on plaintiffs under the Reform Act to allege facts pertaining to a fraud with 'particularity'. Panel C also reports a mean (median) filing delay of 125 (24) days. In other words, one-half of all class actions are filed within twenty-four days. We distinguish between rapid and delayed filings in certain of our empirical tests. Likewise, Panel D reports the mean (median) time between CAF date and dismissal date (for the 455 class

¹⁶ ISS is the world's leading provider of proxy voting and corporate governance services and serves more than 950 institutional and corporate clients worldwide. Its core business is to analyse proxies and issue research and vote recommendations for more than 10,000 U.S. and 12,000 non-U.S. shareholder meetings each year.

¹⁷ While this 'Friday' effect may be an interesting anecdotal observation about the work habits of plaintiff class action law firms, it can affect the price response on event day one, which is more likely to be a Monday. We thus observe that the established tendency for stock prices to decline on Mondays may be attributable, in part, to lawyers' tendencies to file complaints containing bad news on the last day of the week, although we do not test this hypothesis.

INFORMATION: PRICE RESPONSE TO FRAUD LITIGATION

TABLE 1

SECURITIES CLASS ACTIONS: CHARACTERISTICS BY YEAR

Year		1990-93	1994-95	1996-97	1998-99	2000-01	2002	Total
Panel A: Filing dates (number)								
Total	All	169	555	444	599	807	355	2,929
Weekday	Monday	28	110	95	98	127	59	517
	Tuesday	31	97	87	120	150	61	546
	Wednesday	32	112	71	123	152	64	554
	Thursday	43	103	78	123	143	69	559
	Friday	35	133	113	135	235	102	753
Uniform distribution over weekday								
χ^2		n.s.	n.s.	**	n.s.	***	***	***
Panel B: Class period (days)								
Mean		391	519	422	392	324	434	411
Median		266	361	268	288	253	436	296
Number obs.		148	626	490	463	725	359	2,811
Post Reform Act less pre-Reform Act: <i>t</i> statistic, significance							-5.582	***
Panel C: Filing Delay (Days from End of Class Period)								
Mean		139	88	88	105	164	145	125
Median		3	5	26	18	122	46	24
Number obs.		149	496	405	612	786	368	2,816
Post Reform Act less pre-Reform Act: <i>t</i> statistic, significance							2.863	***
Panel D: Dismissal (days from filing date)								
Percent dismissed		9.5%	20.2%	23.0%	23.2%	9.9%	1.7%	15.5%
Mean		962	435	658	520	444	224	528
Median		972	381	516	492	419	248	465
Post Reform Act less pre-Reform Act: <i>t</i> statistic, significance							-1.022	n.s.
Panel E: Settlement amount (\$ millions)								
Mean		\$7.96	\$9.18	\$10.21	\$23.85	\$11.93	\$25.85	\$13.10
Median		\$3.45	\$2.33	\$3.06	\$3.63	\$3.25	\$12.50	\$3.00
Number obs.		145	410	277	323	155	15	1,325
Post Reform Act less pre-Reform Act: <i>t</i> statistic, significance							4.836	***
Panel F: Settlement to end of class period market capitalization (percentage)								
Mean		15.2%	6.1%	6.6%	9.5%	5.9%	0.1%	8.1%
Median		2.7%	1.8%	2.2%	2.4%	1.9%	0.1%	2.1%
Number obs.		105	298	208	256	123	2	992
Post Reform Act less pre-Reform Act: <i>t</i> statistic, significance							0.410	n.s.

ABACUS

TABLE 1

(CONTINUED)

Year	1990-93	1994-95	1996-97	1998-99	2000-01	2002	Total
Panel G: Allegation type (number)							
Accounting	60	237	209	337	313	254	1,410
Non-Accounting	96	352	243	322	532	121	1,666
Total	156	589	452	659	845	375	3,076
Percentage accounting	38.5%	40.2%	46.2%	51.1%	37.0%	67.7%	45.8%
Post Reform Act less pre-Reform Act Accounting: <i>t</i> statistic, significance						3.766	***

This table summarizes the securities class action database by year and by characteristic. See Table 3 for definitions of the characteristics and partitions. *Source:* Institutional Shareholder Services, Inc. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

actions dismissed or 15.5 per cent of the sample). This dismissal period appears to have not changed significantly since the Reform Act (pre-Act mean less post-Act mean = -38 days, $t = -1.022$).¹⁸ Panels E and F provide summary information on settlements. The sample contains data on 1,325 settlements, whose mean (median) per class action are \$13.1 (\$3.0) million. While settlement amounts have increased over time (Panel E, $t = 4.836$), the ratio of settlement to market capitalization has not (Panel F, $t = 0.410$). Indeed, if anything, this ratio may have decreased.¹⁹ Finally, Panel G shows the split between accounting and non-accounting allegations. Overall, 45.8 per cent of the sample reflects allegations on accounting issues. The data also suggest that the ratio of accounting to non-accounting allegations has increased since the passage of the Reform Act ($t = 3.766$).²⁰ We recognize this change in the mix of class action allegations in analysing the results.

Conduct of the tests of investor response requires information on daily stock return and market capitalization. This is obtained from the Center for Research in Security Prices (CRSP) database through 31 December 2002. Table 2 shows the reduction in sample size as a result of this CRSP requirement. Daily return data on 2,194 class actions or 74.9 per cent of the ISS sample for the same period are obtained. Table 2 also provides a breakdown of the CRSP sample by industry (SIC code) (Panel A),

¹⁸ This result, however, also reflects the fact that the more recent cases have not been in the system long enough to be dismissed at normal rates. Indeed, the more recent cases are those that can be dismissed quickly and, hence, the lower percentages and lower days to dismissal.

¹⁹ We also obtain qualitatively identical results when we deflate settlement by market capitalization at BCP and CAF dates. However, Buckberg *et al.* (2003) report a decrease in the ratio of settlement to a measure of investor damages, where the latter is based on the decline in price as a result of the corrective disclosure at ECP date.

²⁰ The next section summarizes the procedures used to identify class actions with accounting allegations versus those without accounting allegations. Grundfest and Perino (1997) and Kelly (2000) also observe a tendency of plaintiffs to allege accounting frauds with greater frequency since the adoption of the Reform Act.

INFORMATION: PRICE RESPONSE TO FRAUD LITIGATION

TABLE 2

SAMPLE AND DATA: BY YEAR AND INDUSTRY

Year	SIC	1990-93	1994-95	1996-97	1998-99	2000-01	2002	Total
Panel A: Class action filing (CAF) dates (number)								
CAF Dates	All	169	555	444	599	807	355	2,929
CRSP returns missing	All	55	92	105	128	185	170	735
CRSP missing percent	All	32.5%	16.6%	23.6%	21.4%	22.9%	47.9%	25.1%
CRSP returns available	All	114	463	339	471	622	185	2,194
SIC industry code	1	2.6%	3.0%	2.7%	1.5%	1.0%	3.8%	2.1%
	2	18.4%	13.2%	8.6%	10.6%	8.0%	11.4%	10.6%
	3	24.6%	30.9%	27.7%	24.4%	21.7%	19.5%	25.1%
	4	6.1%	5.4%	8.6%	6.2%	12.9%	16.8%	9.2%
	5	7.9%	14.3%	10.9%	13.0%	6.6%	7.0%	10.3%
	6	20.2%	12.5%	11.8%	12.7%	7.6%	11.9%	11.4%
	7	9.6%	14.0%	20.6%	24.8%	39.1%	21.6%	25.9%
	8	10.5%	6.7%	9.1%	6.8%	3.2%	8.1%	6.4%
	All	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
	All	114	463	339	471	622	185	2,194
Panel B: Average end of class period market capitalization (\$ millions)								
SIC industry code	All	1,360.25	1,129.84	1,272.26	2,081.83	3,793.27	6,579.98	2,810.53
	1	149.11	472.04	858.70	1,740.78	909.47	1,902.06	914.84
	2	2,756.20	1,796.09	2,995.01	2,698.06	9,177.13	19,256.44	6,167.59
	3	1,330.39	1,688.76	1,466.83	1,693.54	4,359.16	4,001.88	2,572.25
	4	951.92	1,403.84	2,304.85	3,365.98	4,852.86	2,565.81	3,386.96
	5	404.56	530.07	442.97	593.78	1,044.73	856.58	660.75
	6	1,738.85	717.50	1,378.86	3,692.55	4,533.48	15,097.01	4,249.08
	7	368.28	671.45	919.39	2,101.50	2,831.02	5,039.13	2,403.44
	8	540.92	371.40	668.18	975.78	407.85	1,214.08	686.64
Panel C: Median end of class period market capitalization (\$ millions)								
SIC industry code	All	110.31	116.94	175.93	184.87	266.91	381.01	197.76
	1	87.02	104.47	377.62	961.02	323.11	221.74	166.75
	2	137.52	159.11	251.68	245.70	315.41	1,281.37	244.22
	3	228.44	119.78	187.13	147.04	381.28	417.21	184.29
	4	94.87	152.75	179.97	267.73	297.36	442.35	296.33
	5	138.25	92.75	88.74	157.77	105.93	136.92	119.99
	6	69.69	84.59	125.40	187.21	205.70	729.07	136.52
	7	148.35	125.08	259.12	184.87	243.99	337.87	224.38
	8	95.99	198.70	148.18	219.54	347.24	279.68	217.35

This table summarizes the class action sample by year, industry, and the availability of return data on the CRSP database. SIC Codes are as follows: 1-Mining and Construction; 2,3-Manufacturing, 4-Transportation and Public Utilities; 5-Wholesale and Retail Trade; 6-Finance, Insurance, and Real Estate; 7,8-Services.

and mean (Panel B) and median (Panel C) market capitalization as of the ECP date. First, Panel A reveals an increase in companies in SIC codes 7000–7999 and a decrease in the 6000–6999 category. This is consistent with a change in mix of industries in the economy to service companies (including technology and computer software companies) from financial and other companies (including banks). We control for industry mix in the empirical analysis. Panels B and C summarize the distribution of market capitalization across the study period. Both the mean and median market capitalization increase over the study period, but not in all industry categories. Median market capitalization, however, is considerably less than the mean, indicating that the distribution is highly skewed. Where appropriate, there is a logarithmic transformation of market capitalization in the empirical analysis.

UNIVARIATE ANALYSES

These tests examine the direction and magnitude of stock price response to securities fraud litigation at the ECP, CAF and BCP dates. Stock price response for a defendant firm is measured as the three-day excess stock return over days –1 to 1, where day 0 is the event date. Excess return is defined in two ways: one, as the excess of return over return on the market portfolio (based on the value weighted CRSP market index), and two, as an industry-adjusted daily excess return. We calculate industry-adjusted excess return by subtracting from each issuer's daily CRSP return the average return for all CRSP firms with the same three-digit SIC code. This return removes common market and industry effects from the raw return, and hence controls for systematic industry effects and potential statistical dependence in the event of clustered observations. While the tests use both excess return definitions, the tables that follow are based on market-adjusted return, and the industry-adjusted return metric is used as a robustness check (see Robustness Analysis).

Tables 3a and 3b present summary statistics describing the stock price response to the litigation events on event days –1, 0, and 1. Table 3a presents results for partitions of the sample based on firm size, type of allegation, industry, and filing delay, and tests also whether on a univariate basis investor response differs within a partition. Table 3b shows the breakdown by year of class action filing. The partitions are defined as follows: Firm size is relative to median market capitalization as of the event date, where the median is calculated each year. A technology company is defined as one having an SIC code in the 2830s, 3750s, 3670s, 3840s, 7370s, 8730s, or 3825–29 category (Jones and Weingram 1996). A delayed filing is one made five or more days following ECP date. Finally, the partition on allegation is based on a keyword search of the litigation summary in the ISS database. Variants of the following words and phrases were used to identify cases of accounting allegation: failure to disclose, revenue, sales, expense, accounting, misrepresent, false and misleading, inventory, financial statement, earnings, GAAP overstatement, auditor, and restatement.²¹ All other class actions were classified as

²¹ Bajaj *et al.* (2000) use a similar scheme to classify allegations into accounting and non-accounting categories.

INFORMATION: PRICE RESPONSE TO FRAUD LITIGATION

TABLE 3A

TESTS OF RESPONSE TO SECURITIES CLASS ACTION EVENTS ON DAYS -1 TO 1:
BY PARTITION

	Mean	SD	10% tr. mean	Median	t stat.	Signif.	Count
Panel A: End of class period (ECP)							
All	-0.166	0.384	-0.163	-0.137	-19.94	***	2,133
Smaller	-0.188	0.277	-0.182	-0.167	-20.72	***	937
Smaller minus larger					-2.34	**	
Acctg allegation	-0.243	0.252	-0.230	-0.220	-31.41	***	1,060
Acctg minus non-acctg					-9.44	***	
Tech.	-0.180	0.283	-0.177	-0.149	-16.58	***	680
Tech. minus non-tech.					-1.17	n.s.	
Delayed	-0.165	0.426	-0.166	-0.141	-14.89	***	1,481
Rapid minus delayed					-0.25	n.s.	
Panel B: Beginning of class period (BCP)							
All	0.036	0.171	0.022	0.013	8.87	***	1,801
Smaller	0.039	0.181	0.022	0.012	5.96	***	760
Smaller minus larger					0.65	n.s.	
Acctg allegation	0.028	0.184	0.018	-0.011	4.88	***	999
Acctg minus non-acctg					-2.04	**	
Tech.	0.037	0.163	0.028	0.018	5.08	***	494
Tech. minus non-tech.					0.23	n.s.	
Delayed	0.034	0.171	0.020	0.012	6.85	***	1,160
Rapid minus delayed					0.45	n.s.	
Panel C: Class action filing (CAF)							
All	-0.041	0.180	-0.029	-0.017	-11.10	***	2,194
Smaller	-0.045	0.192	-0.038	-0.024	-7.00	***	881
Smaller minus larger					-0.03	n.s.	
Acctg allegation	-0.072	0.192	-0.050	-0.028	-12.00	***	1,025
Acctg minus non-acctg					-7.44	***	
Tech.	-0.044	0.191	0.033	-0.021	-6.18	***	718
Tech. minus non-tech.					-0.50	n.s.	
Delayed	-0.014	0.130	-0.012	-0.010	-3.86	***	1,347
Rapid minus delayed					-11.06	***	

This table summarizes the univariate tests of stock price reaction on days -1 to 1 and across the following partitions of the ISS class action sample defined as follows: All = All firms in the ISS sample; Smaller = relative to median market capitalization in class action year; Accounting allegation = based on keyword search in ISS allegation summary; Technology company = based on selected SIC codes; Delayed = based on filing five or more days following end of the class period. Stock price reaction measured as market-adjusted excess return over days -1 to 1 relative to each event date. The *t*-test significance levels are for a two-sided test. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

ABACUS

TABLE 3B

TESTS OF RESPONSE TO SECURITIES CLASS ACTION EVENTS ON DAYS -1 TO 1:
BY YEAR

Year of class action filing	Mean	SD	10% tr. mean	Median	t-stat.	Signif.	Count
Panel A: End of class period (ECF)							
All	-0.166	0.384	-0.163	-0.137	-19.94	***	2,133
≤1993	-0.176	0.261	-0.156	-0.131	-6.99	***	107
1994	-0.171	0.207	-0.175	-0.169	-11.63	***	199
1995	-0.180	0.226	-0.179	-0.177	-10.22	***	164
1996	-0.225	0.247	-0.215	-0.205	-10.50	***	133
1997	-0.179	0.237	-0.166	-0.139	-9.72	***	165
1998	-0.167	0.882	-0.213	-0.234	-2.90	***	234
1999	-0.214	0.258	-0.210	-0.190	-12.25	***	219
2000	-0.192	0.355	-0.194	-0.141	-7.99	***	219
2001	-0.066	0.260	-0.047	-0.037	-5.24	***	432
2002	-0.215	0.231	-0.203	-0.179	-14.46	***	243
Panel B: Beginning of class period (BCF)							
All	0.036	0.171	0.022	0.013	8.87	***	1,801
≤1993	0.016	0.133	0.013	0.016	1.18	n.s.	102
1994	0.044	0.147	0.025	0.015	3.83	***	167
1995	0.018	0.115	0.011	0.000	1.96	*	155
1996	0.042	0.153	0.016	0.009	2.90	***	114
1997	0.021	0.124	0.018	0.011	2.11	**	154
1998	0.035	0.118	0.024	0.013	4.40	***	224
1999	0.075	0.286	0.038	0.018	3.97	***	230
2000	0.024	0.186	0.013	0.009	1.92	*	221
2001	0.034	0.176	0.030	0.014	2.41	**	154
2002	0.035	0.145	0.025	0.022	3.86	***	263
Panel C: Class action filing (CAF) (delayed only)							
All	-0.014	0.130	-0.012	-0.010	-3.86	***	1,347
≤1993	0.009	0.107	-0.001	-0.010	0.56	n.s.	40
1994	-0.022	0.183	-0.003	-0.004	-1.15	n.s.	91
1995	0.005	0.096	0.000	-0.002	0.54	n.s.	90
1996	0.008	0.100	0.002	-0.004	0.73	n.s.	90
1997	0.008	0.141	-0.005	-0.006	0.60	n.s.	119
1998	-0.037	0.130	-0.034	-0.025	-3.47	***	145
1999	-0.022	0.123	-0.021	-0.015	-2.10	**	138
2000	-0.010	0.130	-0.011	-0.009	-0.87	n.s.	126
2001	-0.013	0.113	0.010	-0.008	-2.09	**	355
2002	-0.026	0.160	-0.016	-0.011	-1.95	*	142

This table summarizes tests of stock price reaction on days -1 to 1 by year of class action filing. Stock price reaction is measured as market-adjusted excess return over days -1 to 1 relative to each event date. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

involving non-accounting allegations, such as breach of fiduciary duty and insider trading violation. This partition is far from perfect, and because most class actions involve multiple allegations, this binary partition at best emphasizes the tendency of each category to reflect a particular kind of allegation.

The summary statistics are based on all issuers in each partition with complete data for each statistic, and include the mean, standard deviation, 10 per cent trimmed mean, median, and a one-sample *t*-test of the sample mean versus a null of zero excess return. Also reported is a two-sample *t*-test of the difference in mean excess return for each partition against a null of zero. Significance levels are reported for a two-sided test.

Panels A of Tables 3a and 3b document the investor response at ECP date. Consistent with earlier work (see Introduction), stock price reaction is significantly negative. For the 2,133 class actions with return data, the mean (median) response is -16.6 (-13.7) per cent over the three-day window (Table 3a), and this response is uniformly negative over all years (Table 3b). The response at ECP date is more negative for smaller firms ($t = -2.34$) and accounting allegations ($t = -9.44$) but no different for technology firms ($t = -1.17$) or delayed class action filings ($t = -0.25$) than the other firms.

Panels B of Tables 3a and 3b document the investor response at BCP date. As predicted, the overall reaction is positive and significant on this date. For 1,801 cases, the mean (median) response is 3.6 (1.3) per cent over the three-day window (Table 3a), and this response is uniformly positive over all years (Table 3b). The only difference within the partitions is on the basis of allegation. The (positive) response at BCP date to class actions with accounting allegations is less than the response for non-accounting allegations. This could occur if accounting wrongdoings are not as fully revealed at the beginning of the class period compared to other forms of wrongdoing.

Panels C of Tables 3a and 3b document the investor response at CAF date. For the 2,194 class actions, the mean (median) response is -4.1 (-1.7) per cent over the three-day window (Table 3a), which is highly significant ($t = -11.10$). The response at CAF date is also more negative for accounting allegations ($t = -7.44$), less negative for delayed class action filings ($t = -11.06$), and no different for smaller firms ($t = -0.03$) or technology companies ($t = -0.50$) compared to the others. Since the stock price effects of rapid filings can overlap with the price effects at ECP, Panel C of Table 3b documents the investor response across years for delayed filings only. This panel shows that while the overall response to delayed filings is significantly negative ($t = -3.86$), this response is due primarily to reactions at CAF dates in the later years. Class action filings are apparently more informative for investors in those later years. Two possibilities might explain this. One is that litigation news in the later years is available at lower cost (e.g., it is often quickly posted on class action web sites). The other is that the news contains more information since mean filing delay has increased since the Reform Act (Table 1, Panel C), and this increases the possibility of additional information at CAF date that was not available at ECP date. Also, post-Reform Act class action filings are more likely to involve accounting allegations whose effects tend to be more negative (Table 3a, Panel C).

Overall, these results indicate a significant and immediate negative response on ECP and CAF dates and a significant positive response on BCP date, and thus they support Hypothesis 1 (H1a, H1b and H1c). The results also support Hypotheses 2 and 3 in that excess return is more negative for smaller firms at ECP date (H2a) and firms with accounting allegations at ECP date (H3a) and CAF date (H3b).²² We caution, however, that a more definitive conclusion regarding Hypotheses 2 and 3 can only be drawn after controlling for these and other factors that might jointly account for differences in response. These factors are examined below using multiple regression.

Because securities class action fraud is revealed to investors in a series of sequential events that can be costly to analyse, the market may not digest fully the implications of each event consistent with the traditional definition of market efficiency (i.e., immediate and unbiased response to the news event) and, as such, a short-window analysis may not reflect adequately the cost to an issuer of a decrease in market value. We examine this aspect of investor response by calculating excess return over days 3 to 10 following each event day 0.

Table 4 presents the results. Table 4a indicates a mean excess return of -2.8 per cent in days 3 to 10 following the ECP date ($t = -6.26$) (Panel A), 1.2 per cent in days 3 to 10 following the BCP date ($t = 3.59$) (Panel B), and essentially no change in mean excess return in days 3 to 10 following the CAF date (Panel C). Thus, mean excess return continues to drift in the direction of the initial price response at ECP and BCP but not at CAF date. However, examining post-announcement excess return by year and across the three partitions does not reveal any consistent pattern to indicate that the price momentum is uniform across years or partitions or has systematically increased or decreased over time (e.g., as a result of the Reform Act). For instance, Table 4a reports that the response to accounting allegations is less negative after ECP and more negative after the CAF. Table 4b, also, shows that the drift in prices is highly non-uniform across years. As such, we interpret the results in Tables 4a and 4b as more consistent with a market that reacts quickly and unbiasedly to corrective disclosure information and litigation announcements than one that reflects significant price momentum. Further, given the costs and risks of exploiting negative accounting announcements for profit (e.g., as a short sale), these data are unlikely to be economically or financially significant.²³

²² We also examined investor response to accounting allegations on the three event dates by type of accounting allegation. The data indicate that investors responded more negatively to allegations involving misstatements of 'sales' or 'revenue' than other accounting allegations at the ECP date but not at the other event dates, although the sign of the difference in return (accounting less non-accounting) was negative at CAF date and positive at BCP date, consistent with the ECP results. The mean excess return on ECP days -1 to 1 for revenue allegations is -27.6 per cent ($n = 448$) versus -21.9 per cent for non-revenue accounting allegations ($n = 612$), and this difference is statistically significant at a 1 per cent confidence interval. No other partitions showed a significant difference at or following any of the event dates. Results available on request.

²³ Richardson (2002) provides evidence to suggest that the costs and risks of exploiting adverse accrual information outweighs the potential for profit. It is possible, however, that some investors make informed predictions about forthcoming corrective disclosures prior to ECP date. See also note 6.

INFORMATION: PRICE RESPONSE TO FRAUD LITIGATION

TABLE 4A

TESTS OF RESPONSE TO SECURITIES CLASS ACTION EVENTS ON DAYS 3 TO 10:
BY PARTITION

	Mean	SD	10% tr. mean	Median	t-stat.	Signif.	Count
Panel A: End of class period (ECP)							
All	-0.028	0.209	-0.028	-0.021	-6.26	***	2,152
Smaller	-0.022	0.240	-0.029	-0.022	-2.87	***	954
Smaller minus larger					1.18	n.s.	
Acctg allegation	-0.011	0.195	-0.014	-0.015	-1.81	*	1,072
Acctg minus non-acctg					3.87	***	
Tech.	-0.045	0.220	-0.043	-0.034	-5.39	***	682
Tech. minus non-tech.					-2.58	**	
Delayed	-0.037	0.221	-0.035	-0.023	-6.51	***	1,498
Rapid minus delayed					2.96	***	
Panel B: Beginning of class period (BCP)							
All	0.012	0.160	0.005	0.000	3.59	***	2,152
Smaller	0.004	0.166	-0.002	-0.003	0.82	n.s.	1,066
Smaller minus larger					-2.28	**	
Acctg allegation	0.009	0.141	0.003	-0.001	2.21	**	1,164
Acctg minus non-acctg					-0.84	n.s.	
Tech.	0.029	0.201	0.018	0.009	3.94	***	726
Tech. minus non-tech.					3.55	***	
Delayed	0.016	0.174	0.008	0.003	3.76	***	1,584
Rapid minus delayed					-1.98	**	
Panel C: Class action filing (CAF)							
All	-0.005	0.178	-0.008	-0.005	-1.49	n.s.	2,194
Smaller	-0.012	0.210	-0.017	-0.014	-1.71	*	882
Smaller minus larger					-1.05	n.s.	
Acctg allegation	-0.017	0.190	-0.017	-0.015	-2.88	***	1,026
Acctg minus non-acctg					-2.91	***	
Tech.	-0.009	0.188	-0.014	-0.016	-1.24	n.s.	720
Tech. minus non-tech.					-0.58	n.s.	
Delayed	0.002	0.179	-0.004	-0.004	0.42	n.s.	1,332
Rapid minus delayed					-3.03	***	

This table summarizes the univariate tests of stock price reaction on days 3 to 10 and across the following partitions of the ISS class action sample defined as follows: All = All firms in the ISS sample; Smaller = relative to median market capitalization in class action year; Accounting allegation = based on keyword search in ISS allegation summary; Technology company = based on selected SIC codes; Delayed = based on filing five or more days following end of the class period. Stock price reaction measured as market-adjusted excess return over days 3 to 10 relative to each event date. The *t*-test significance levels are for a two-sided test. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

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TABLE 4B

TESTS OF RESPONSE TO SECURITIES CLASS ACTION EVENTS ON DAYS 3 TO 10:
BY YEAR

Year of class action filing	Mean	SD	10% tr. mean	Median	t-stat.	Signif.	Count
Panel A: End of class period (ECP)							
All	-0.028	0.209	-0.028	-0.021	-6.26	***	2,152
≤1993	-0.014	0.152	-0.023	-0.003	-0.93	n.s.	108
1994	-0.001	0.126	-0.007	-0.009	-0.12	n.s.	200
1995	-0.017	0.128	-0.021	-0.027	-1.74	*	167
1996	0.001	0.137	0.000	-0.003	0.10	n.s.	134
1997	-0.019	0.144	-0.021	-0.014	-1.71	*	169
1998	0.002	0.180	-0.011	-0.017	0.18	n.s.	237
1999	-0.017	0.192	-0.019	-0.021	-1.33	n.s.	218
2000	-0.025	0.236	-0.035	-0.025	-1.57	n.s.	218
2001	-0.097	0.286	-0.096	-0.068	-7.07	***	438
2002	-0.014	0.230	-0.016	-0.014	-0.92	n.s.	245
Panel B: Beginning of class period (BCP)							
All	0.012	0.160	0.005	0.000	3.59	***	2,152
≤1993	0.016	0.131	-0.001	-0.003	1.32	n.s.	116
1994	0.010	0.094	0.001	-0.004	1.48	n.s.	214
1995	0.007	0.139	-0.005	-0.006	0.68	n.s.	176
1996	0.019	0.120	0.013	0.010	1.87	*	138
1997	0.011	0.100	0.005	0.005	1.55	n.s.	187
1998	0.003	0.124	0.003	-0.008	0.45	n.s.	258
1999	0.006	0.115	0.003	-0.001	0.80	n.s.	242
2000	0.002	0.185	-0.001	-0.006	0.13	n.s.	240
2001	0.027	0.246	0.016	0.010	2.34	**	292
2002	0.009	0.140	0.007	0.013	1.03	n.s.	289
Panel C: Class action filing (CAF) (delayed filings only)							
All	0.002	0.179	-0.004	-0.004	0.42	n.s.	1,332
≤1993	0.000	0.115	0.000	-0.001	0.01	n.s.	39
1994	0.009	0.112	0.004	0.006	0.76	n.s.	91
1995	-0.008	0.127	-0.012	-0.016	-0.59	n.s.	90
1996	-0.027	0.111	-0.031	-0.030	-2.33	**	90
1997	-0.002	0.177	-0.008	-0.001	-0.15	n.s.	118
1998	0.000	0.193	-0.009	-0.012	-0.01	n.s.	145
1999	0.005	0.203	-0.005	-0.012	0.28	n.s.	138
2000	-0.003	0.202	-0.006	0.000	-0.19	n.s.	124
2001	0.005	0.192	-0.002	0.005	0.45	n.s.	354
2002	0.027	0.191	0.019	0.009	1.69	*	143

This table summarizes tests of stock price reaction on days 3 to 10 by year of class action filing. Stock price reaction is measured as market-adjusted excess return over days three to ten relative to each event date. Significance levels are *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

INFORMATION: PRICE RESPONSE TO FRAUD LITIGATION

TABLE 5

TESTS OF RESPONSE TO SECURITIES CLASS ACTION EVENTS ON DAYS -1 TO 1:
BY AMOUNT OF SETTLEMENT

	Mean	SD	10% tr. mean	Median	t-stat.	Signif.	Count
Panel A: End of class period (ECP)							
All	-0.166	0.384	-0.163	-0.137	-19.94	***	2,133
High settlement	-0.246	0.261	-0.238	-0.234	-20.21	***	467
Low settlement	-0.136	0.641	-0.150	-0.113	-4.58	***	461
High minus low sttl.	-0.110				-3.41	***	928
Panel B: Beginning of class period (BCP)							
All	0.036	0.171	0.022	0.013	8.87	***	1,801
High settlement	0.031	0.184	0.016	0.011	3.28	***	444
Low settlement	0.042	0.184	0.027	0.019	4.79	***	366
High minus low sttl.	-0.010				-0.80	n.s.	810
Panel C: Class action filing (CAF)							
All	-0.041	0.180	-0.029	-0.017	-11.10	***	2,194
High settlement	-0.072	0.204	-0.059	-0.043	-7.38	***	462
Low settlement	-0.051	0.203	-0.033	-0.018	-5.40	***	431
High minus low sttl.	-0.021				-1.57	n.s.	893
Panel D: Class action filing (CAF) (delayed only)							
All	-0.014	0.130	-0.012	-0.010	-3.86	***	1,347
High settlement	-0.001	0.144	-0.012	-0.014	-0.10	n.s.	213
Low settlement	-0.023	0.146	-0.011	-0.008	-2.43	**	239
High minus low sttl.	0.022	0.000	0.000	0.000	1.60	n.s.	452

This table summarizes tests of stock price reaction on days -1 to 1 and a partition of the ISS sample based on the amount of settlement: All = All firms in the ISS sample; High settlement = Settlement/End of class period market capitalization greater than median = High, less than median = Low; Stock price reaction measured as market-adjusted excess return over days -1 to 1 relative to each event date. The *t*-test significance levels are for a two-sided test. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

Finally, Table 5 shows that excess return varies at ECP date on the basis of the amount of settlement. The mean excess return at ECP date to class actions with higher settlements of -24.6 per cent is significantly different from the mean excess return of -13.6 per cent for class actions with lower settlements ($t = -3.41$). The differences are not significant, however, on the other event dates.

REGRESSION ANALYSIS

The univariate analysis presented in the preceding section demonstrates a significant statistical relationship for an individual factor, but it does not control for coincident factors that may show a similar statistical relationship (e.g., settlement

amount, type of allegation). Ordinary least squares regression is used to estimate the incremental effect of one factor after controlling for the explanatory power of the other factors.

Regression Variables and Models

The dependent variable for the multiple regression is excess stock return at ECP date for days -1 to 1. We examine how this measure of price response varies with excess stock return on CAF date and outcomes of the litigation such as dismissal and settlement. Controls for other factors indicated in the previous section are used to explain partially the dependent variable. The variables are:

EECP = Market-adjusted excess return for days -1 to 1 at end of class period (ECP).

ECAF = Market-adjusted excess return for days -1 to 1 at class action filing (CAF).

ALEG = Accounting allegation = 1, otherwise 0.

EBCP = Market-adjusted return for days 1 to 10 at beginning of class period (BCP).

DISM = Dismissed = 1, otherwise 0.

MCAP = Log of market capitalization at end of class period (ECP).

STTL = Settlement/end of class period market capitalization (settlement ratio) greater than median settlement ratio = 1, otherwise 0.

TECH = Technology company if SIC code = 2830s, 3750s, 3670s, 3840s, 7370s, 8730s, and 3825-3829 = 1, otherwise 0.

A log transformation for market capitalization is used. Otherwise it would be highly skewed and lead to unreliable coefficients of the explanatory power of an independent variable. We estimate a cross-sectional regression model for rapid and delayed filings separately, as the price response for a delayed filing (*ECAF*) should not overlap with *EECP*, which could otherwise induce a spurious positive correlation between *EECP* and *ECAF* due to common information. The model is specified as follows:

$$EECP_{it} = \alpha + \beta ECAF_i + \delta ALEG_i + \eta EBCP_i + \gamma DISM_i + \rho MCAP_i + \phi STTL_i + \kappa TECH_i + \varepsilon_{it} \quad (1)$$

We test whether the regression coefficients in (1) are positive, zero or negative, depending on the sign predicted by the hypotheses. Given the prior discussion, we expect $\beta < 0$ if the more negative the price response at ECP, the less negative the response at CAF; $\delta < 0$ if investors respond more negatively to class actions with accounting allegations; $\eta < 0$ if investor responses at ECP 'correct' the price inflation at BCP; $\gamma > 0$ if investors anticipate dismissals; $\rho > 0$ if smaller firms experience a more negative market response; $\phi < 0$ if investors anticipate the amount of the settlement; and $\kappa < 0$ if investors respond more negatively to litigation-naming technology firms. If investors anticipate the event of and/or the outcome of the litigation at ECP date, then the coefficients β , γ and ϕ should be statistically significant in the direction predicted above.

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TABLE 6

CORRELATIONS AMONG EXCESS RETURN AT END OF CLASS PERIOD (*EECP*) AND SECURITIES CLASS ACTION AND OTHER EXPLANATORY VARIABLES

	<i>EECP</i>	<i>ECAF</i>	<i>ALEG</i>	<i>EBCP</i>	<i>DISM</i>	<i>MCAP</i>	<i>STTL</i>	<i>TECH</i>
<i>EECP</i>	1.000	3.914 ***	-9.371 ***	-4.053 ***	-2.568 **	2.922 ***	-4.965 ***	-1.165 n.s.
<i>ECAF</i>	0.074	1.000	-7.41 ***	2.872 ***	0.20 n.s.	0.92 n.s.	-6.739 ***	-0.503 n.s.
<i>ALEG</i>	-0.170	-0.122	1.000	-0.808 n.s.	1.93 *	0.235 n.s.	3.935 ***	1.438 n.s.
<i>EBCP</i>	-0.102	0.073	-0.027	1.000	0.462 n.s.	1.926 *	-0.205 n.s.	1.443 n.s.
<i>DISM</i>	-0.039	0.007	0.045	0.018	1.000	2.266 **	0.717 n.s.	-10.139 ***
<i>MCAP</i>	0.048	-0.004	0.030	0.030	0.040	1.000	-0.252 n.s.	1.284 n.s.
<i>STTL</i>	-0.082	-0.118	0.037	-0.005	-0.225	-0.004	1.000	-2.491 **
<i>TECH</i>	-0.061	-0.017	0.036	0.041	0.041	0.008	-0.039	1.000

This table reports the Pearson correlations (below the diagonal) and significance levels (above the diagonal) among *EECP* (the dependent variable) and the independent variables in the regression analyses (Table 7). The variables are defined as follows: *EECP* = Market-adjusted excess return for days -1 to 1 at end of class period; *ECAF* = Market-adjusted excess return for days -1 to 1 at class action filing; *ALEG* = Accounting allegation = 1, otherwise 0; *EBCP* = Market-adjusted return for days 1 to 10 at beginning of class period; *DISM* = Dismissed = 1, otherwise 0; *MCAP* = Log of market capitalization at end of class period; *STTL* = Settlement/End of class period market capitalization greater than median settlement ratio = 1, otherwise 0; *TECH* = Technology company if SIC code = 2830s, 3750s, 3670s, 3840s, 7370s, 8730s, and 3825-9 = 1, otherwise 0. Number of observations = 1,614. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

Correlations Among the Variables

Table 6 reports the product moment correlations among the variables. This checks for collinearity, which if highly significant could affect the estimation and interpretation of the regression coefficients. First, the direct correlations between *EECP* and the independent variables are noted. Except for dismissals, these are consistent with the univariate analysis and the effects predicted above. Table 6 shows that the correlations among the independent variables are generally low. The largest correlation is between *DISM* and *STTL* (-0.225). One would expect a negative correlation, however, as dismissed firms are defined as a unit dummy variable (and are not settled). We also derived correlation matrixes for rapid and delayed filings separately. The correlations are similar, except that the correlation between *EECP* and *ECAF* is positive and significant ($p < .001$) for rapid filings (0.549) and negative and significant ($p < .001$) for delayed filings (-0.152).

Regression Results

Table 7 present the results for all firms (Panel A), larger firms (Panel B) and smaller firms (Panel C) for rapid and delayed filers. In each case, we report the regression coefficients, the significance of a t -test that the coefficient is zero versus the sign predicted by the hypothesis, the adjusted R^2 , and an F -test of the significance of the overall regression. This table offers the following observations. Overall, the adjusted R^2 statistics are larger for rapid filings than for the delayed filings. This occurs because of the overlap between *ECAF* and *EECP* responses for rapid filings, which induces the higher R^2 . The coefficient on *ECAF* is significantly

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TABLE 7

REGRESSION RELATION BETWEEN EXCESS RETURN AT END OF CLASS PERIOD (EECP) AND SECURITIES CLASS ACTION AND OTHER EXPLANATORY VARIABLES

Independent variable	Rapid filer			Delayed filer		
	Exp. sign	coefficient	Signif.	Exp. sign	Coefficient	Signif.
Panel A: All firms						
Intercept		-0.109	*		-0.302	***
ECAF	+	0.564	***	- or 0	-0.515	***
ALEG	-	-0.088	***	-	-0.139	***
EBCP	-	-0.067	n.s.	-	-0.287	***
DISM	+	0.002	n.s.	+	-0.032	n.s.
MCAP	+	0.015	n.s.	+	0.048	***
STTL	-	-0.031	n.s.	-	-0.077	**
TECH	-	-0.026	n.s.	-	-0.022	n.s.
F value		39.944	***		10.747	***
Adjusted R ²		0.327			0.061	
Number of obs.		563			1,051	
Panel B: Larger firms						
Intercept		-0.283	***		-0.221	n.s.
ECAF	+	0.675	***	- or 0	-1.636	***
ALEG	-	-0.036	*	-	-0.164	***
EBCP	-	0.042	n.s.	-	-0.589	***
DISM	+	0.005	n.s.	+	-0.063	n.s.
MCAP	+	0.046	***	+	0.05	n.s.
STTL	-	-0.058	**	-	-0.166	**
TECH	-	-0.066	***	-	-0.012	n.s.
F value		49.716	***		-17.317	***
Adjusted R ²		0.505			0.159	
Number of obs.		335			604	
Panel C: Smaller firms						
Intercept		0.198	n.s.		-0.125	n.s.
ECAF	+	0.365	***	- or 0	0.027	n.s.
ALEG	-	-0.160	***	-	-0.096	***
EBCP	-	-0.185	*	-	-0.174	***
DISM	+	-0.023	n.s.	+	0.017	n.s.
MCAP	+	-0.054	n.s.	+	-0.011	n.s.
STTL	-	0.023	n.s.	-	0.008	n.s.
TECH	-	0.023	n.s.	-	-0.001	n.s.
F value		8.264	***		3.307	***
Adjusted R ²		0.183			0.035	
Number of obs.		228			447	

This table summarizes the regression relation between market-adjusted excess return at the end of the class period over days -1 to 1 and the class action variables. See Table 6 for the definitions of the variables. The significance levels test the hypothesis (two-sided) that the coefficient is zero. *** $p < .001$, ** $p < .01$, * $p < .05$, n.s. = not significant.

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positive in all three panels for rapid filings, also a result of the overlap. The more appropriate sample, however, is for delayed filings, since the *CAF* response should be independent of the *ECP* response.

Panel A shows that the coefficients are generally of the predicted sign and thus consistent with the hypotheses. The coefficient on *MCAP* is positive and significant (Hypothesis 2), the coefficient on *ALEG* is negative and significant (Hypothesis 3), and the coefficients on *ECAF*, *EBCP* and *STTL* are negative and significant (Hypotheses 4 and 5). The incremental explanatory power of *TECH* is not significantly different from zero. Also, after controlling for the amount of the settlement and the other variables, *DISM* adds no additional explanatory power to the regression. The results in Panels B and C are similar although not uniformly significant across smaller and larger firms. *ALEG* and *EBCP* are significant for smaller and larger firms. The coefficients on *ECAF* and *STTL*, however, are significant only for larger firms.

In short, the response of investors to a corrective disclosure that leads to a class action filing at the *ECP* date appears to be associated not only with the event of a class action filing several days or weeks later (at *CAF* date) but also varies on the basis of the amount of the settlement. These results appear, though, to be driven more by the larger firms in the sample. Investors in larger firms, therefore, respond at *ECP* date as if they are able to anticipate the outcome of expected class action securities litigation (Hypothesis 5).²⁴ This result is also robust to alternative variable definitions and specifications of the regression model, which are discussed in the next section, along with other sensitivity checks.

ROBUSTNESS ANALYSIS

This section examines the results under different definitions of the variables and specifications of the regression model. All tests were conducted based on industry-adjusted excess return and over a five-day holding period, from days -2 to 2^{25} ; also tests are based on market capitalization at the other event dates. The results are qualitatively similar under these alternative definitions and procedures. Results were examined using a different definition of filing delay, namely that a delayed filing occurs ten or more days after the *ECP* date. The results changed in one respect only. The association between *EECP* and *ECAF* for delayed filings becomes less negative and is not significantly different from zero. This result was expected, however, in that the longer the period between the *ECP* and *CAF* dates, the more likely that new information drives the investor response at *CAF* date, which in an efficient market should be independent of the price response at *ECP*

²⁴ This result is also consistent with the view that plaintiffs can later extract larger payments from firms that suffer larger price declines even if that factor is not anticipated by the market. This response may not be evident among smaller firms because their capacity to pay larger settlements is often constrained by limited assets and less insurance coverage.

²⁵ The procedures used to measure industry-adjusted excess return are given above. All results are available on request.

date. In addition, the regression model was estimated using log of the settlement amount as the *STTL* variable with no change in the overall results.

Additional independent variables were included in the regression also, with no qualitative change in the results. For instance, we included measures of security risk (systematic 'beta' risk, excess return volatility in a non-event period), a dummy variable to partition the sample into pre-Reform Act and post-Reform Act class action filings, and different measures of the lag between filing date and the due date to file a claim (claim date) (a potential proxy for the complexity of the case).²⁶ These variables did not add any additional explanatory power beyond the variables in regression model (1).

We also extended our tests of possible delayed reaction following each litigation event, as reported in Table 4, by examining excess return for up to thirty days following day 0, with no qualitative change in the results. Figure 1 plots the cumulative mean daily excess return from days -20 to 30 relative to each event day, partitioned by accounting and non-accounting allegations. For presentation purposes, the cumulative mean excess return is set to zero as of day 0. Panel A shows that the cumulative excess return around the BCP date increases over this period. While this may reflect the view that these firms are performing well generally, this increase in cumulative excess return after BCP day 0 (the class period) also suggests that the allegedly false information at or after BCP date may be having the desired effect. On the other hand, as shown in Panels B and C of Figure 1, there is little indication of a sustained over- or under-reaction to news at the ECP or CAF dates, when the allegedly false information is revealed to the market. The cumulative excess return for days -20 to 30 for other partitions (e.g., revenue and non-revenue accounting allegations) were examined with no change in the results.

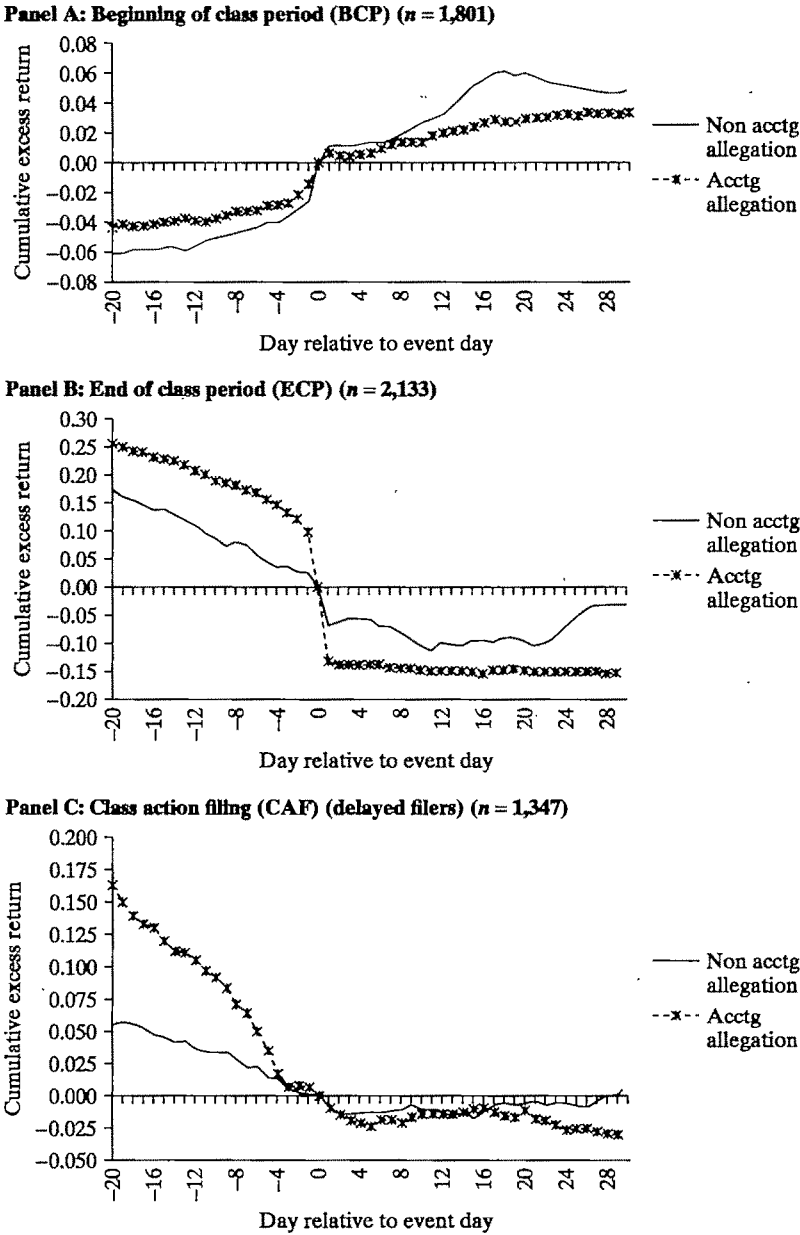
In addition, this section includes some preliminary results on investor reaction at the dismissal (DIS) and settlement (STL) dates, which are two subsequent stages in the chronology of litigation events. Ideally, it would have been useful to test the association between investor response at these dates and the responses at the earlier dates as part of the correlation and regression analysis. But the class action database yielded samples too small to include in such analysis. We therefore summarize the market response at these dates as separate events only. First, the mean excess return for 196 dismissal announcements on days -1 to 1 is -1.37 per cent ($t = -2.63$). As such, the overall response at dismissal date is negative (although the mean response on days 0 and 1 is insignificantly different from zero). An analysis of the mean response for different partitions of the sample (e.g., size, allegation type, industry, filing delay), however, failed to reveal one group in particular with a significant differentiating effect. Also the results showed no difference in mean excess return between early and late dismissals (DIS date less CAF date). We suspect that the response to dismissals is subtler than this initial analysis. For example, the test did not consider other post-filing steps in the legal process

²⁶ Investors are required to file a claim prior to a 'claim' date, which is established by the court for each class action. Other things being equal, the longer the period between the filing date and claim date, the more complex the litigation and, potentially, the greater the merits of the allegations.

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FIGURE 1

CUMULATIVE EXCESS RETURN OVER DAYS -20 TO 30 RELATIVE TO EVENT DAY



This figure reports the cumulative average daily excess return (CAER) for securities class action companies from -20 to 30 days relative to the litigation event partitioned by allegation (non-accounting or Accounting). CAER is set equal to zero on day 0 and measured as market-adjusted excess return.

(e.g., rulings on summary judgment, opinions from other jurisdictions) that might further inform investors about the chances of dismissal. Some dismissals, moreover, may only eliminate some but not all allegations, and other dismissals may simply be the prelude to an amended filing.

Second, the work documents the mean investor response to seventy-nine settlement announcements, sixty-one of which provided details about the settlement amount. These settlements were announced in 1999 through 2002 only. The mean excess return is 2.96 per cent ($t = 1.85$) on days -1 to 1 and 5.48 per cent ($t = 2.02$) on days -2 to 2 . The market response is higher for larger settlements and smaller firms, although given the small sample size this difference is not statistically significant. Hence, for our sample the announcement of a settlement is good news to investors. Such announcements should also be good news for issuers whose effect on market capitalization is apparently at least a partial offset to the amount of the settlement. Whether these same results would generalize to the full sample is contestable. A more detailed analysis of dismissal and settlement announcements could be the subject for future study.

Finally, certain descriptive characteristics of the class actions (e.g., distribution of class periods, settlements) and the litigation firms (e.g., distribution of firm size, type of allegation, industry) are qualitatively identical to those similar characteristics documented in other analyses of large samples of federal class action filings, for example, Bajaj *et al.* (2000), who study 1,203 class action filings over 1988 through 1999, and Buckberg *et al.* (2003) who examine 2,910 class actions over 1990 through June 2003. These studies have different objectives, however. One would expect such similarity in that a high percentage of the lawsuits are common to all three data sources.

CONCLUSION

This study has examined the investor response to three events that help define securities class action fraud litigation, namely, the corrective disclosure at the end of the class period (ECP), the class action filing triggered by the corrective disclosure (CAF), and the event that signifies when the securities fraud is alleged to have begun—at the beginning of the class period (BCP). These events comprise mostly routine news of financial statement corrections and/or violations of insider trading and other company requirements that trigger a sharp stock price decline. The analysis also included the more celebrated cases of substantial fraud, such as Enron, WorldCom and Tyco, that have drawn considerable public attention to the securities class action litigation process. The findings in this study should provide a greater understanding of how the stock market responds to private securities litigation and therefore imposes costs on shareholders and issuers as a decline in market capitalization.

The mean excess returns over days -1 to 1 to the ECP, CAF and BCP events are -16.6 per cent, -4.1 per cent and 3.6 per cent, respectively. We find that the market responds to these events sequentially and conditionally and in ways that are correlated with the outcome of the litigation. The response at CAF date appears to be

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conditional on the response at ECP date, and the response at ECP date appears to reflect the event of a filing and the amount of the settlement.

Further, the market imposes a greater cost on an issuer when the allegations relate to accounting issues, which have increased in relative frequency in recent years. There was limited evidence of momentum in excess return in the direction of the immediate price change around each event, but one should be cautious to attach significance to these results because they are non-uniform or unsystematic over time.

Finally, although we analyse a large sample of federal securities class actions, the analysis of the price response at the ECP and BCP dates still reflects a selection bias. The population of corrective disclosures that could lead to securities class action litigation was not analysed in its entirety. Rather, only those that precipitate a class action filing were examined. While we suspect that the population of all corrective disclosures (those that allegedly correct false or misleading information) and those that trigger lawsuits is similar, because plaintiffs' counsel have incentives to file even if the merits of the case are not strong, ultimately this is an empirical issue. It is unclear how one would generate an appropriate sample of corrective disclosures that, potentially, could trigger a lawsuit but do not. We observe, however, that the sample of class action filings includes only a small number of dismissed cases that, arguably, should be more similar to those cases where the disclosure did not trigger a class action in the first place than those that were settled or adjudicated.

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The Profits of the Dutch East India Company's Japan Trade

This article analyses the eighteenth-century accounting practices of the Japanese trading station or factory of the Dutch East India Company (*Vereenigde Oost-Indische Compagnie* or VOC). The factory's trade and its reported profits declined during the eighteenth century, but because of the complexity of the accounting issues involved, contemporaries held different views on whether the accounting data supported a continuation of the factory's operations. For similar reasons, some historians have argued that the maintenance of the factory in the face of declining profits illustrates the poor quality of the VOC's management, while others have argued in favour of the economic viability of the factory. The purpose of this article is to a more comprehensive analysis of the accounting issues facing the Japanese factory present in the eighteenth century than offered to date, in order to propose a way in which the accounting records may be approached as a source of data for historical research.

The conclusions are twofold. First, there were three main accounting issues facing the factory that should be considered when interpreting the accounting records. These issues can be summarized as transfer pricing, currency translation and overhead allocation. While all these issues have been recognized in the literature at some stage, they have never been considered in combination. Second, we tentatively conclude that if the recorded accounting figures are adjusted as proposed, they support the view that keeping the factory open was a correct decision from a commercial point of view.

Key words: Accounting; Currency translation; (Dutch) East India Company; History; Overhead costs, allocation; Profits; Transfer pricing.

One of the main features of Japanese history is that, from 1639 to 1854, the country pursued a policy of national seclusion with very limited contacts with the outside world, and in particular tried to isolate itself from European influence. A fact that has stimulated historical interest is that one exception to this policy was allowed. The Dutch East India Company (*Vereenigde Oost-Indische Compagnie* or VOC) was allowed to maintain a small trading station or factory throughout this period, which served as Japan's sole link with the West.

The first Westerners arrived in Japan from Portugal in 1543. This opened almost a century of fairly free access to Japan by European traders and missionaries, with

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both groups enjoying considerable success. During this period, a permanent Dutch trading post was set up in 1609 on the island of Hirado. In 1600, Ieyasu Tokugawa's rapid rise to national power in Japan culminated in victory at the battle of Sekigahara. In 1603, when he was designated shogun, he became the actual ruler of Japan even though the imperial house continued to reign in name. The Tokugawa family dominated political life in Japan until the restoration of the emperor Meiji in 1868.

During the first decades of the seventeenth century, the spread of Christianity began to be seen as a threat to the authority of the new ruler as it was seen to be backed by the power of Spain and Portugal. This led to the adoption of the 'closed country' (*sakoku*) policy, which was introduced by five directives in the course of the 1630s. These directives, in effect, banned ships and individuals from leaving Japan, prohibited Christianity and expelled all Europeans with the exception of a limited number of Dutchmen. In 1641, the Dutch were transferred from Hirado to Deshima, a small man-made island in Nagasaki bay, in order to ensure greater control. The Dutch trading post, or factory (*factorij*), remained on Deshima until 1860. Throughout the 'closed country' period it was, together with restricted numbers of Korean and Chinese merchants, one of the few channels of overseas trade and Japan's only link with the West.

The unique vantage point of the factory, offering a glimpse of Tokugawa Japan through European eyes, coupled with the excellent state in which its archives have been preserved, help explain the attention that it has received from historians.¹ But even though the history of the factory is closely linked with the political history of Japan, it should be kept in mind that, from the VOC point of view, the factory was primarily a commercial operation. Therefore, the question as to whether the Japan factory was in fact profitable or not has been frequently posed, both when it was still in operation and by subsequent historians. During the eighteenth century, the volume of trade declined, and as the century progressed the factory began to report 'losses'. While there were recurrent discussions as to whether to close the factory, this was never done and the Deshima factory continued trading into the 1840s, well beyond the demise of the VOC in 1798. At this point, an accounting issue enters the story. It was already clear to some of the VOC's officials in the eighteenth century that the reported accounting profits might not correctly represent the net benefits of the Japan trade to the VOC. But since the accounting issues were quite complex, both contemporaries and historians have expressed differing views on the degree to which the accounting profits reflected the underlying economics of the Japan trade. Perhaps as a result, historians have also differed in assessing the role played by accounting information and, more generally, considerations of profitability in the decision to keep the factory open throughout the eighteenth century.

The purpose of this article is to offer a more comprehensive analysis of the accounting issues facing the Japan factory in the eighteenth century than offered to

¹ Goodman (2000) is an important study in its own right and a good introduction to the literature.

date, in order to propose a way in which the accounting records may be approached as a source of data for historical research concerning the VOC. Our objective is therefore not 'to award prizes or to assign demerits' (Miller and Napier, 1993, p. 639) by arguing that the VOC should or should not have accounted in a certain way. The article also does not consider the VOC's accounting practices against the wider background of the history of accounting technique, even though this might well merit further research.

The conclusions of this article are twofold. First, there were three main accounting issues facing the factory that should be considered when interpreting the accounting records. These issues can be summarized as transfer pricing, currency translation and overhead allocation. While all these issues have been recognized in the literature at some stage, they have never been considered in combination. Second, we tentatively conclude that if the recorded accounting figures are adjusted in the way proposed here, they support the view that keeping the factory open was a correct decision from a commercial point of view.

THE VOC'S TRADE WITH JAPAN IN THE 18TH CENTURY²

The VOC's activities were centred on the Indonesian archipelago, with Batavia (now Jakarta) representing its Asian headquarters. Batavia also served as the hub of a wider network of about twenty-five trading posts scattered along the coasts of Asia. These did not merely purchase goods for shipment to Europe, but also maintained an extensive trade among themselves which made the VOC an important player in intra-Asian trade. In the early eighteenth century, the volume of trade within Asia was nearly twice as large as the volume of trade between Asia and Europe. As the century progressed, this ratio gradually fell towards one.³ The Japan factory was an important element in this network. In the seventeenth century, its main function was as a source of silver and gold which served as lubricants of the Asian trade. In addition, copper was an important export. When the Japanese stopped the export of silver in 1671 and reduced the export of gold to a trickle during the subsequent fifty years, copper became by far the most important article exported by the VOC. Copper was acquired in Japan in exchange for whatever combination of European and Asian manufactures or primary products appeared to be in demand in Japan. In the eighteenth century, Japanese copper was mainly shipped to India (Coromandel, Bengal and Surat) where it was exchanged for local manufactures (textiles) which were traded both in Asia and Europe.

This basic pattern of trade, which from the Dutch point of view was focused on obtaining maximum quantities of precious metals and copper, did not change when the VOC factory was moved to Deshima in 1641. The trading mechanism,

² The overview in this section is based primarily on Feenstra Kuiper (1921), Roessingh (1964), Goodman (2000) and Jacobs (2000).

³ Jacobs (2000, Tables 1 and 35).

however, was fundamentally altered. In Hirado, trade had been largely free and conducted directly with Japanese merchants or local magnates throughout the year. On Deshima, government controls increasingly confined trade to a strict pattern. These controls were inspired by Japanese concern about the outflow of metals and the depletion of mines, as well as the possibility of a destabilizing influence through direct contacts between the Japanese and foreigners.⁴ To the Dutch, it was often not clear whether restrictive measures originated with the Tokugawa government or with the local authorities in Nagasaki. Both had an interest in continuing the trade, but did not necessarily agree about the way in which the benefits ought to be shared. In this way, the performance of the VOC factory in Japan was intertwined with the fortunes of the Tokugawa government, which was at its strongest in the seventeenth century and tried to regain its position by successive attempts at reform during the eighteenth and nineteenth centuries.

Quotas, taxation and the imposition of other costs helped to reduce the volume of trade. Whereas in the 1640s up to ten Dutch ships might visit Japan each year, this number fell to at best three but more often one or two during the eighteenth century (see tables in Mulder, 1985, and Feenstra Kuiper, 1921). The attractiveness of trade was also reduced from 1696⁵ onwards by a series of alterations in the metal content of the gold coinage, which the VOC had been exporting in large quantities. A change of particular significance was the monopolization of trade on the Japanese side. Until the end of the seventeenth century, the VOC would transact with individual merchants, with some competition to settle the terms of trade. In 1698, the Nagasai *kaisho* ('Chamber of Commerce' or 'Clearing House'; known as *geldkamer* or 'money chamber' by the Dutch) was established.⁶ The role of this office was to centralize the handling of foreign trade, both Dutch and Chinese. In the eighteenth century, the VOC began to act, in effect, as a broker for the *geldkamer*, which in turn acted as the VOC's banker. The *geldkamer* would allot the VOC an annual quota of copper at fixed prices (by then the only significant export allowed to the VOC), and stipulated the nature, quality, quantity and prices of import goods required in return. The entrepreneurial activities of the Dutch chief factor (agent) were by then largely limited to annual haggling over the size of the copper quota and over alleged deficiencies in the quality of the imported goods (see Meylan, 1833, Appendix).

Trade continued on this basis until the end of the eighteenth century. In 1798, the virtually bankrupt VOC was dissolved and its Asian possessions were taken over by what then became the government of the Netherlands East Indies. Trade at Deshima came to a standstill shortly afterwards when Dutch shipping was chased

⁴ Feenstra Kuiper (1921, pp. 104–6, 118–19, 152–3).

⁵ 1696 mentioned in Van Imhoff (1853, p. 326), 1698 by Feenstra Kuiper (1921, p. 97).

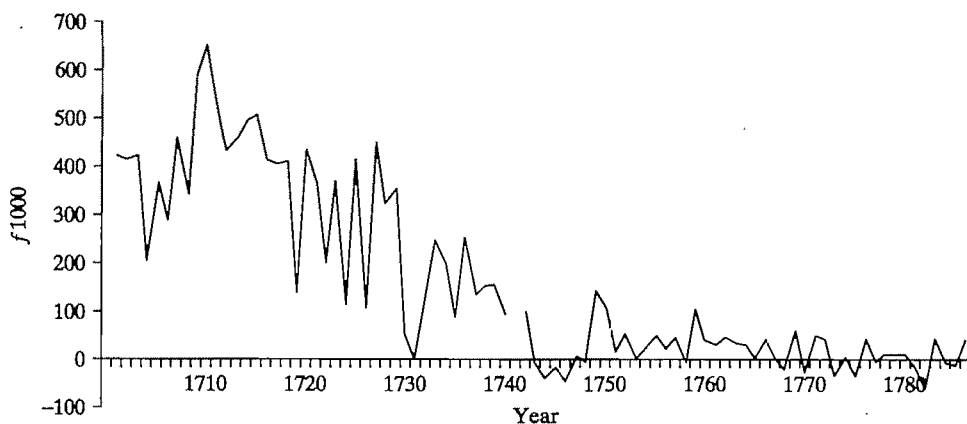
⁶ Feenstra Kuiper (1921, p. 94n) distinguishes between the *geldkamer* and the *kaisho*. See, however, Jansen (2000).

from the seas by the British fleet during the Napoleonic wars.⁷ As the Japanese did not allow non-Dutch shipping to land, the factory was isolated but it remained permanently occupied by Dutch officials. Trading was resumed in the nineteenth century, although no longer as part of the VOC organization. As the accounting practices during this period were also rather different, this period falls outside the scope of this article (see Camfferman and Cooke, 2001). In the 1840s, Deshima was changed 'from a trade station into a sort of pre-diplomatic residence' (Roessingh, 1964, p. x), and in 1860, following the opening of Japan to the outside world, the position on Deshima was abandoned.

THE EMERGENCE AND HISTORY OF THE PROFITABILITY DISCUSSION

Whereas in the seventeenth century the profitability of the Japan trade, based on the export of huge quantities of precious metals, was so obvious as not to require much discussion, by the eighteenth century it was becoming clear that, for the reasons outlined above, the golden years were over. At that point the question emerged, not whether profits were lower, but whether they were still sufficient to justify continued operations. Figure 1 shows the decline in reported profits experienced during the eighteenth century.⁸ What was obvious from such figures was that

FIGURE 1
REPORTED PROFITS, 1701-86



Source: Feenstra Kuiper (1921, Appendix III).

⁷ See Veenhoven (1950) for Deshima during the Napoleonic period.

⁸ 'Reported profits' is defined here as the gross margin reported as the balance of the profit and loss account minus the overhead costs charged directly to Batavia ('equity').

profits were in structural decline, certainly compared with the seventeenth-century high-water marks of around a million guilders per year. What was less obvious was whether they declined to a marginally positive level, as seemed to be the case when the figures were taken at face value, or whether the 'true' profits had in fact turned into systematic losses. As will be discussed below, there was sufficient awareness of the influence of accounting policies on profits to justify such doubts.

As early as 1703, the VOC's Court of Directors⁹ in the Netherlands questioned the desirability of keeping the factory open, mainly because of the debasement of the Japanese gold coin (Van Imhoff, 1853, p. 330). The Batavia government¹⁰ advised against this, partly because of strategic considerations (fear of competition by the English), and partly because profits were still not unsatisfactory. Similar discussions were carried on at irregular intervals throughout the eighteenth century, typically prompted by the imposition of new restrictions on trade by the Japanese. In the various memoranda and resolutions on this issue a whole range of important but uncertain factors determining the viability of the Japan trade were considered, such as the political situation in Japan and the balance of power between factions or regions, the actual production of copper, as well as the nature and extent of trade carried on by Chinese competitors.

For our purpose, two reports are of particular importance because they question the appropriateness of accounting for the Japan trade. These are reviews of the Japan trade written in 1744 by Governor-General G.W. Van Imhoff (in office 1742–50)¹¹ and by former chief factor Van der Waeyen in 1756.¹² Although Van der Waeyen depended heavily on Van Imhoff for his historical review, his discussion of accounting issues, as will be seen below, was original. Two points emerged from these reviews. The first was that the net benefits of the Japan trade should not be judged merely or even primarily on the basis of profits on imports alone, but above all on the basis of the profits on exported copper when sold in India. This point was not altogether new at the time,¹³ but evidently required to be highlighted once again, perhaps because it was not evident from the accounting data. As will be discussed below, the profits on copper did not appear in the accounts of Deshima, because the copper was transferred at cost. Yet to Van Imhoff, copper was 'the bride for which we dance' and the main reason for trading on Japan (Feenstra Kuiper, 1921, p. 130).

⁹ Also referred to in the English-language literature by their Dutch appellations of *Bewindhebbers* and *Heeren XVII*, or in English as 'the Seventeen'.

¹⁰ Our translation of *Hoge Regeering* or Asian chief executive, a council of some seven members also known as *Raad van Indië*. Council of India, presided over by the Governor-General.

¹¹ References to this memorandum are to the edition published in 1853.

¹² Nationaal Archief (NA), Den Haag, Inventaris van archivalia afkomstig van de Hoge Regering, 1602–1827, 1.04.17, No. 154, 'Beschrijving van den Handel der Nederlanders in Japan'.

¹³ The point was already made, for instance, in a 1683 memorandum by Rijckloff van Goens, Jr, former member of the Batavia government (see Gaastra, 1989, p. 153).

The second issue recognized by the middle of the eighteenth century was that in the accounts, kept in guilders, transactions in Japanese currency were converted at fixed rates that did not reflect changes in the value of Japanese gold or silver currency. Measures to redress this, according to Van Imhoff, 'have given rise to confused calculations and hence to various errors which, in my opinion, have contributed greatly to bring the Japanese trade to such an advanced state of decay' (Van Imhoff, 1853, pp. 329-30). As will be seen below, Van Imhoff proposed accounting measures to address both issues. On the basis of insights like these, the Batavia government concluded that the factory was in fact fairly profitable. Nevertheless, the Japan trade remained a cause of concern during the remainder of the eighteenth century, but primarily because of recurrent difficulties with the Japanese authorities and not because of direct concerns about the accounting records.

After the demise of the VOC came the time for reflection. In 1833, Hendrik Doeff, who had been chief factor from 1804 to 1817, stated his belief that the factory had on the whole been profitable during the eighteenth century, even though this was not clear from the accounts. He argued that profits on copper and profits on imports should be considered as a whole, and that the division of profits between the two rested on arbitrary conversion rates for the Japanese currency. Placing a higher value on Japanese currency would increase sales revenues and profits on imports, but it would also increase the purchase price of copper. The combined profits on imported goods and exported copper would by and large be unaffected (Doeff, 1833, pp. 64-6).

The next major investigation of the VOC's Japan trade in the eighteenth century was carried out by Feenstra Kuiper (1921), whose work is still very useful to anyone wanting to study the Deshima factory. Compared to Doeff, his analysis is rather gloomier. Although he recognizes the importance of considering the value of both export and import trade, he describes the Japan trade as a whole as 'one that could not live vigorously yet could not die either' (p. 156). This he blamed at least in part on incapable or careless management that characterized the VOC as a whole. The failure to adjust the accounting conversion rate to changes in the value of Japanese currency is, for instance, described as being 'not too strange for a corporation that was so hard to interest in any change, where confused accounting and monetary calculation were so at home, and where there was such a strong tendency to close the accounts with pleasing figures, even if they were purely illusory' (p. 97). Moreover, Feenstra Kuiper also suggested that, whatever the profitability of the Japan trade or whatever the merit of strategic arguments such as keeping the English out of Japan, an important reason why the Batavia government wanted to keep the factory open was that it offered opportunities for personal enrichment through private trade. While this applied to staff of all ranks, the factory was thought to be a plum job for high ranking officials who could make a fortune by spending a year or two as chief factor in Japan before retiring to the Netherlands (pp. 119, 160, 163). Feenstra Kuiper also argued that similar considerations played a role on the Japanese side, where Nagasaki merchants, officials and interpreters all had an interest in continuing the Dutch trade, whatever the view of the national government in Edo.

This negative verdict linked the issue of the Japanese profits with the scathing criticism on the VOC's management and accounting practices in general published in 1922 by Mansvelt. His sweeping verdict that these were 'antediluvian' gave rise to the incorrect but widespread view that the VOC did not use double entry bookkeeping (see Yamey, 1994, and Lemarchand, 1993, citing Coornaert, 1955). Studies subsequent to Mansvelt have modified this negative view. Glamann's seminal (1958) work on the VOC's Asian trade set the tone by arguing, first of all, that at a local level (the accounts of the Persian factory are mentioned as an example) 'it is possible from the accounts to read practically all that one would expect to read out of a modern account' (p. 252). Moreover, according to Glamann, the directors were aware of the weak points of their accounting system and negotiated their way around them by supplementary estimates made outside the accounts.

Subsequent studies (e.g., de Korte, 1984; Gaastra, 1989; Westera, 1992) have continued to highlight the considerable shortcomings in the VOC's accounting system, but also to downplay them again by emphasizing the awareness of the directors to these problems, by highlighting the difficulties involved in correcting them and by attributing a more modest role to the formal accounting system next to less structured forms of management information (see also Van Zanden, 1996, for a short summary of this discussion). While most of this discussion was carried on with reference to 'top-level' forms of accounting referring to the total of the VOC's (Asian) trade, Glamann's point about the importance of data supplementing the formal accounts was developed by Klein (1984) with direct reference to the Japan factory.

Klein (1984) studied the so-called 'returns' (*rendementen*) prepared by the factory from 1746 to 1782, which were in effect lists of gross margins on the VOC's imports into Japan. Rendementen were prepared by all factories and, according to Glamann (1958, p. 258) 'these lists were the corner-stones in the Company's commercial policy'. Klein is less sanguine as he concludes that there is no apparent relation between the realized profit margins on the various products and the composition of the cargoes of imported goods in subsequent years. In spite of Glamann's assertions about the importance of the *rendementen* for determining commercial policy, Klein showed that the VOC continued to import loss-making products into Japan. Moreover, Klein also drew attention to late eighteenth-century efforts to charge gross margins with a share of overhead costs. According to Klein, the results of these calculations show 'how diseased and loss-making the import trade on Japan really was' and that the continuation of that trade appears to be an instance of 'failing entrepreneurship' (p. 201). This last conclusion does not necessarily follow, because Klein does not allow for the possibility that in the eighteenth century the Japan trade was carried on because of the copper exports and not because of profits on imports. Nevertheless, Klein's analysis is valuable because it draws attention to the issue of fixed costs or overheads which, at around 40 per cent of the cost of import goods, were certainly substantial. Although Klein's figure of 40 per cent may be open to question, as discussed more fully below, the issue is clearly important.

Even though Glamann (1958, pp. 258–9) shows by means of an example that the VOC's directors (in 1631) understood the importance of indirect costs in relation to gross margins, and though Van der Waeyen discussed this point in his 1756 memorandum, it appears that discussions about the profitability of the Japan trade have been carried on almost exclusively in terms of gross margins.¹⁴

Steur's (1984) study of the VOC's Asian trade in the second half of the eighteenth century also considers the Japan trade. His calculations take into account the sale of copper in India and the costs of transport, but he takes the reported cost price of the copper at face value, thus avoiding the currency issue. Finally, Jacobs' (2000) lucid summary of the eighteenth-century Japan trade (part of a reconstruction of the VOC's intra-Asian trade patterns), does recognize the crucial importance of copper exports and the fact that accounting profits could be made to fall either in Japan or India by adjusting the accounting conversion rate between guilders and Japanese gold currency. She also mentions that 'private trade... was a never openly pronounced argument to keep Deshima open' (p. 122), but on balance she judges the 'official view' to be correct, that Japanese copper was indispensable for the VOC's trade in India and that 'the high profits on copper in India were more than sufficient to maintain trade contacts with Japan in the eighteenth century'. However, as overhead costs were explicitly left out of her study (pp. 119, 221) the point raised by Klein (1984) still requires attention.

Our literature review shows that, while there is agreement on the main features of the VOC's Japan trade, there is scope for further analysis of the accounting aspects of its profitability. In particular, three accounting issues (transfer price of copper exports, currency conversion and overhead) appear to be particularly relevant. Although all three have at some stage received attention in the prior literature, this article contributes to the literature by discussing them in more detail and by considering their joint impact on the profits of the Japan factory.

USE OF ARCHIVAL DATA

The following sections consider how the three main issues of revenues on exports, currency translation and overhead costs were handled in the course of the eighteenth century. This is possible because the accounting records of the Japan factory have been very well preserved (see Roessingh, 1964, for a general introduction and inventory). Fairly complete series of journals and ledgers are available, as well as related documents such as invoices and warehouse lists.¹⁵ In addition, there are references to accounting matters scattered throughout the correspondence between the factory, Batavia and the Netherlands which are only partially accessible through indexes. Our approach in dealing with this extremely voluminous material has been to start with a close study of the journals and ledgers of the 1740s and 1750s.

¹⁴ See, for instance, the analysis of the VOC's Asian trade prepared in 1772 by director Cornelis van der Oudermeulen, as discussed in Steur (1984, p. 83).

¹⁵ NA, Archief Factorij Japan, 1.04.21, Nos 829–974 (*journals*) and 975–1120 (*grootboeken*).

As indicated above, this was a period during which the viability and profitability of the factory were seriously discussed. We have analysed the treatment of the three accounting issues during this period and have then attempted to find relevant related material in the records of other decades (to find out how and when practices changed) and in other parts of the archive (orders to change accounting practices, analyses of accounts, etc.). Although at this stage of the process we were supported by internal references in the archival sources and by the secondary literature, it is likely that we will have uncovered only some of the relevant facts. Nevertheless, we believe that we come to a reasonable understanding of the development of the accounting procedures which adds substantially to the modern literature on the subject.

REVENUES ON EXPORTS AND TRANSFER PRICING

The basic structure of the Deshima journal and ledger did not change over the seventeenth and eighteenth centuries and was probably typical for all VOC factories.¹⁶ Ignoring for the moment cost and sundry accounts and considering merely the movement of trade goods, the ledger contained the following accounts:

- merchandise accounts for imported goods, which made up about two-thirds of the total number of accounts in the eighteenth century,
- a 'cash' account (*cassa*),
- a profit and loss account (*winst en verlies*), and
- an account for the Batavia General Office (*comptoir generael*), which served in effect as the equity account.

The Japan trade consisted of a single annual convoy of ships sailing between Batavia and Japan and their departure from Japan marked the start of a new accounting year. The merchandise accounts were debited for opening stocks, with a credit to the General Office. During the year, sales were debited to cash and credited to merchandise. Purchases of exports (e.g., copper) were credited to cash and debited to General Office, and the same would be true for transfers of bullion or minted coin to Batavia. There were therefore no separate accounts in the ledger for exported goods. At the end of the accounting year the merchandise accounts were closed to profit and loss and to the General Office (for closing stock). Transferring the profit or loss to the General Office account closed the annual accounting cycle.

The transfer of commodities at cost was applied as a general principle by the VOC, both for shipments between Asian stations and between Batavia and the Netherlands. As a rule, profits would be deemed to have been realized only at the point of sale to third parties (Gaastra, 1989, p. 80). In the late seventeenth century, this was very conspicuous in the case of Japanese gold, which yielded

¹⁶ The Japan factory is unique in the extent to which its accounts have been preserved. See Roessingh (1964) and Meilink-Roelofs (1992) for information on the Japan archives and those of the VOC in general. From bookkeeping instructions and preserved fragments of accounts of other factories it seems reasonable to assume that the Japan accounts were similar to those of other factories.

profits over the purchase price of 25 to 170 per cent in Batavia or Coromandel.¹⁷ In the decades around 1700, Japanese copper could regularly be shipped to Europe to compete profitably with Swedish copper (Glamann, 1985, pp. 173–80). Clearly, the size of these profits depended on the amount entered into the books in Japan, which depended in turn on the conversion of purchase prices from local currencies to guilders, an issue discussed in the next section. The point here is that, however determined, all of the profits or losses were recorded by the receiving station. Because the rule was fairly consistently applied, it was not unusual for some stations to report permanent losses. Banda and Ambon, to name two conspicuous examples, received little credit for the spices they produced and on which the VOC realized huge monopoly profits (Gaastra, 1989, p. 80).

But even though it was understood that a station reporting losses was not necessarily a cause for concern, the resulting figures for the Japan factory were not always found to be satisfactory. In the course of the eighteenth century some attempts were therefore made to adjust the transfer prices of gold and copper.

In the case of gold, the debasement of the Japanese gold coin in the 1690s turned the profits on reminting in Coromandel into losses. Soon afterwards, in 1701, the Coromandel factory was allowed to charge these losses straight to the General Office rather than having them flow through the profit and loss account (Van Imhoff, 1853, p. 329). In this way, the losses disappeared altogether, because they did not show up in the accounts of the Japan factory either. It was only in 1730 that the Japan factory was ordered to take charge of these losses itself, by lowering the price recorded for exported gold below the cost price and charging the difference to profit and loss (Van Imhoff, p. 329). This experiment was stopped after two years, although it was briefly reinstated when gold exports recovered somewhat in the 1740s.¹⁸ It lost all significance when gold exports ceased altogether in 1752. Although fluctuations in the value of gold first brought the transfer price issue on the agenda, it was ultimately far more important in the case of copper.

As indicated above, Van Imhoff's 1744 memorandum recognized the importance of profits on copper to justify the factory's existence. In accounting terms, this was recognized by an order of June 1749, issued at the close of Van Imhoff's tenure as governor-general, allowing the factory to add a surcharge to the value of the copper charged to Batavia. This amounted initially to about 20 per cent and soon after to nearly 50 per cent of the purchase price of exported copper.¹⁹

¹⁷ Van Imhoff (1853, p. 325n).

¹⁸ The literature is somewhat uncertain about the chronology. Glamann (1958, p. 181) states that the method was introduced in 1729 and discontinued in 1734. Van Imhoff (1853, p. 329n) reports that the instruction was given in March 1730, which matches Feenstra Kuiper's (1921, Appendix III) observation that the method was first applied to the financial year 1729/30. Feenstra Kuiper, however, also notes (p. 117) that the instruction was given in 1729 and was rescinded 'after three years'. The first observation matches Glamann's, the second does not.

¹⁹ The surcharge amounted to a constant f11.30 for a picul of copper, which cost f29.68 (tael 14.84) in 1749. The amount of the surcharge was apparently not adjusted for lower copper prices in taels in 1752, which more than doubled the surcharge as a percentage of purchase price. Neither was the surcharge adjusted for changes in the tael/guilder conversion rate in 1768.

The surcharge was credited to a separate account, to which various expenses were charged before the balance was transferred to the profit and loss account. The surcharge remained in place at least until 1786 (Feenstra Kuiper, 1921, Appendix III).

The surcharge amounted to f11.30 per picul²⁰ or f124,300 per year when the full quota of 11,000 piculs of copper was obtained (which was frequently the case during the 1750s). This was a substantial amount, unlike the adjustments for gold. It can be inferred from Figure 1 that, without the surcharge, the factory would have recorded nothing but losses from 1749 onwards. In assessing the overall profitability of the factory, it is therefore important to know how the surcharge compared to what might loosely be described as the fair value of the copper.

The most interesting insight into this issue was that provided by Van der Waeyen's 1756 memorandum, in which he tries to arrive at an estimate of the factory's profits over a ten-year period ending in 1755. In the spirit of Van Imhoff's memorandum, the main components of gross profit are the profits from imports 'according to the books' and the profits on exports, which he calculated on the basis of actual amounts and purchase prices and estimated resale prices. In Van der Waeyen's calculations, the profits on imports amount (for ten years) to f1.8 million, which is far exceeded by the profits on exports of f7.7 million. Profits on copper bars contributed 97 per cent to the latter figure, suggesting that other exports (mainly camphor, some sheet copper and assorted Japanese manufactures) had become completely marginalized.

It is not clear from the memorandum how Van der Waeyen determined the resale price (*uytkoop*) of copper, which is of course the key assumption. Given that he uses different prices for each of the ten years, which range widely from f57 to f109 per picul, it seems likely that these are based on actual prices realized in India. These prices are compared with the purchase price which, after 1752, settles at f36 *including* the surcharge of f11.30 per picul. If Van der Waeyen's figures are correct, the surcharge introduced in 1749 allocated only a rather small proportion of the profits on copper to Japan. Even after allowing for his treatment of overhead (discussed below), it is understandable that Van der Waeyen concluded his memorandum with the observation that, as long as the Japanese did not restrict the export of copper, 'this office is rather not to be estimated as one of the least profitable, and therefore will have to be maintained'.

Feenstra Kuiper (1921, p. 138) is critical of Van der Waeyen's calculations, describing them as double-counting merely to produce pleasing figures.²¹ We would rather conclude that Van der Waeyen had a realistic grasp of the economic position of the Japan factory within the VOC's Asiatic trade, and that his estimates of widely fluctuating margins inspire more confidence than the flat surcharge of

²⁰ One picul is approximately 60 kilograms (definitions vary from 122 to 125 Amsterdam pounds of 0.494 kg).

²¹ Feenstra Kuiper also criticizes Van der Waeyen for not subtracting the surcharge on copper from the profits on imports. This criticism is not justified as Van der Waeyen displays a clear awareness of the surcharge and is at least consistent by including it in the purchase price of copper.

f11.30 actually used in the accounts. In fact, apart from producing pleasing figures, one can see little justification for a flat surcharge while copper prices in India varied considerably as a result of shifting patterns of competition (see also Jacobs, 2000, p. 119).

Concluding this section, it is noted that the transfer price issue was important mainly with respect to copper, and that other exports can probably be ignored when considering the general impact of transfer pricing on the factory's profits. In addition, it seems likely that the accounting solution adopted by Van Imhoff of a fixed surcharge added to copper was effective in the formal sense of making the factory turn a small profit. This presumably helped to prevent uninformed questioning of the factory's viability based purely on reported profits. But among those who had studied the question, such as Van der Waeyen, there was awareness that a fixed surcharge might not necessarily reflect the actual value of copper.

CURRENCY CONVERSION

The Japan factory's accounts were kept in *guldens* (guilders). Japan was, as far as the VOC was concerned, a money economy, so that its transactions were carried out in local currency which had to be converted into guilders in the accounts. Because both the Japanese and the Dutch currency systems underwent several changes during the eighteenth century, this was a problem of considerable complexity.

The VOC calculated in guilders of twenty *stuivers*, both in Asia and in the Netherlands. Because coins circulating in Asia were generally of a lower quality than those used in the home country, the VOC had decided in the late seventeenth century to distinguish between 'light' and 'heavy' money.²² In principle, the Asian books were kept in 'light' guilders and all incoming cargoes from the Netherlands were booked at 125 per cent of their invoice value. Confusingly, the two types of guilders were not clearly distinguished in the accounts and amounts in 'light' and 'heavy' currency tended to mingle. To end the confusion, the 'light money' was abolished in 1742. However, according to Jacobs (2000) the accounting translation rates between guilders and local Asian currencies were not changed. For the Japan factory this would have meant an inflation of profits, since the value of its imports in guilders would be reduced but the amount of Japanese currency received on sale (assuming stable prices) would remain the same when converted in guilders. To avoid this, and again according to Jacobs, the VOC added a 'profit on shipments' on all cargoes invoiced to factories such as Japan. If this percentage were equal to 25 per cent, the books of the Japan factory would be unaffected in guilder terms. However, as all guilders would henceforth be considered as 'heavy' guilders, this would mean in effect an increase in profits, compensated for by a fall in profits elsewhere in the VOC. The values of the factory's exports, although unaltered in nominal terms, would henceforth be considered to be denominated in 'heavy'

²² The history of the VOC's accounting currencies is quite complex. See Jacobs (2000) for a summary and references to the literature.

money, and therefore more expensive to the receiving station. Because the percentage added for 'profit on shipment' was not uniform for all factories, the situation remained confused. Only in 1768 was the 'heavy' guilder definitely adopted with proper adjustments of the capital accounts of the various factories and of local conversion rates.

The conversion to 'heavy' money in Japan had an effect from the financial year 1743/44. We have not been able to find what percentage or percentages for 'profit on shipment' were applied to Japan. We note, though, that for a selection of merchandise and equipment items imported in 1743 and 1744 there is evidence of a slight fall in invoice prices, suggesting a percentage somewhat less than 25 per cent.²³ In a longitudinal study, therefore, guilder amounts relating to the Japan factory can best be expressed by post-1768 guilders, reducing pre-1743 amounts by 20 per cent and amounts between 1743 and 1768 by 20 per cent as well, or slightly less.

As indicated above, this was one element of the currency question. The other element was the question of fluctuations in the value of the Japanese currency. In a very general sense, this was a non-issue.²⁴ Put simply, the Japan trade consisted of a single voyage a year in which import goods were bartered for copper. Under a historical cost system, the cost price of every annual batch of copper acquired could have been set equal to the total guilder value of the imports. That the imports were sold for Japanese currency which was used to buy the copper did not matter: Any accounting rate to convert sales revenues and the cost of copper into guilders would yield the same final result. As stated above, this was already recognized by Doeffer in 1833. In practice, however, the Japan trade was never so simple. There were always other exports, albeit in minor quantities, and there would be stocks of imports and money balances carried over from year to year. In addition, there were local expenses for the running of the factory paid out of sales revenues which, if there was to be any semblance of control, had to be recorded separately instead of being submerged in the formula: cost price of copper = cost price of imports. Hence, in practical bookkeeping terms, currency conversion was a real issue which had to be faced.

In Japan, the VOC conducted its trade in terms of silver *taels* which was the common unit of account in southern Japan. A tael represented a certain weight of silver, even though there was no silver coinage. In fact, many VOC transactions were not settled in cash but, increasingly so as the century progressed, by means of a current account held at the Money Chamber. Apparently, these 'credit taels' might be at a discount relative to settlements in specie.²⁵ The purity of the silver in

²³ For seventeen items the average fall in invoice price between 1742/43 and 1744/45 is 12.3 per cent with a standard deviation of 20.7 per cent.

²⁴ In this sense, the 'heavy money' and 'light money' question was a non-issue as well, because it did not affect the values in Europe of the in- and outbound cargoes.

²⁵ Feenstra Kuiper (1921, p. 167) observes this in connection with 'credit taels' generated by the officially sanctioned private trade. Whether it also applied to VOC trade is not clear.

circulation was not fixed and tended to decline at least partly because of debasement by the government.²⁶

Next to silver, gold played an important role. In contrast to silver, gold did circulate in minted ingots called *koban*.²⁷ Traditionally, the VOC had exchanged these for silver at a fixed rate of 6.8 taels.²⁸ In 1698²⁹ and 1712³⁰ new *koban* types were issued with less gold content, but which the VOC was forced to accept for the same tael rate. In 1720 the old *koban* was restored, but its exchange rate doubled to 13.6 taels.

As was not unusual within the VOC, the Japan factory used relatively fixed conversion rates for accounting purposes.³¹ From the late seventeenth century to 1744, the tael was valued at 70 stuivers (f3:10), from 1744 to 1768 at 40 stuivers and from 1768 onwards at 33 stuivers.

As will be noted, the change in 1744 coincided with the attempted abolition of 'light' money, but should not be confused with it. The pre-1744 rate of 70 stuivers was denominated in 'light' money, and should therefore have been reduced to 56 stuivers 'heavy'. However, as indicated above, an adjustment of conversion rates for local currencies was not normally part of the abolition of 'light' money. Instead, the adjustment of the tael to 40 stuivers was explained as a long-overdue adjustment to the debasement of the gold *koban* since 1698. In fact, Van Imhoff (1853), who was behind this adjustment of the tael rate, argued that the failure to adjust the accounting to the falling value of the *koban* was a major reason for the decline in the Japan trade. He argued that 'the tael should have been calculated according to the *koban*, as the fixed coin and standard of the realm, and not the *koban* according to the tael' (p. 331). Overvaluation of the tael had led the VOC's officials to offer too little for copper and to be content with low prices for imports. Hence, 'the restoration of the Japan trade must be sought first and foremost in a better calculation, and everything connected to that' (p. 333).

Subsequent authors, including Meylan (1833, p. 166) and Feenstra Kuiper (1921, p. 97), have accepted that the failure to adjust the tael conversion rate was a serious accounting error, even though Feenstra Kuiper (p. 128) doubted whether the Japanese could really have been tempted to supply more copper and to pay higher prices for imports.³²

²⁶ Van Imhoff (1853, p. 329n); Feenstra Kuiper (1921, pp. 62–4).

²⁷ In physical form also referred to as 'kobang' or 'koebang', and, as an expression of value, 'ryo'.

²⁸ The tael was subdivided in ten *maas* of ten *kondarijn* each, to give the Dutch names. For simplicity, tael amounts in the text are presented in decimal format, i.e., 14.84 tael instead of 14:8:4.

²⁹ Feenstra Kuiper (1921, p. 97). Van Imhoff (1853, p. 326) has 1696 but also indicates that old and new *kobans* were issued interchangeably for a while.

³⁰ Feenstra Kuiper (1921, p. 107).

³¹ Inferred from Jacobs (2000, p. 227).

³² Jacobs (2000, p. 119) is less severe but still expresses puzzlement as to why the VOC did not adjust its conversion rate from 1696 onwards.

However, in our opinion the case for accounting error requires that, from the VOC's point of view, there was a general rise in prices expressed in taels. Otherwise, the changes in the value of the koban might just as well be interpreted as a specific price increase of gold. This was clearly inconvenient for the VOC whose Coromandel factory had hitherto reported large profits on the reminting of Japanese gold and now began to show losses, but it should be seen as a matter of changing conditions of trade rather than as an accounting problem.³³

As to price levels in taels, there are indications that prices did indeed rise during the first half of the 18th century.³⁴ However, this does not mean that the VOC should have applied a form of general price level accounting, even in the hypothetical case that the state of accounting knowledge at the time would have allowed it to do so. What matters are the prices paid by the VOC itself. If we accept for the moment that the price increase in gold may have been specific, two other main classes of expenditure need to be considered: copper and local costs of maintaining the establishment. Copper would take roughly 75–80 per cent of the expenditure on the two combined, and some of the remainder, such as the rent of the island Deshima, was fixed in tael terms. It appears that copper prices charged to the VOC were remarkably constant over the eighteenth century.³⁵ In fact, Van Imhoff himself claims that between 1717 and 1744 the price had been fixed at 14.84 taels a picul, which was only slightly higher than prices prevailing in the latter part of the seventeenth century.³⁶ In 1752, the price of copper was fixed again at the 'old' price of 12.35 taels per picul, where it remained at least until the 1820s.³⁷ Apparently, these prices were interpreted from both sides in terms of established privileges and not as reflections of the market value of copper.³⁸ For long periods, the Chinese were charged 24 taels per picul (which Meylan, 1833, p. 313, thought was at least one reason why the local authorities were unwilling to increase copper supplies to the Dutch). According to Meylan 'the price of copper in private trade in Japan is a secret to the Dutch' (p. 322). We would argue therefore that from an accounting point of view, it was immaterial to the VOC whether or not the prices it paid bore any relationship to prices in Japan. What mattered was that the price of its chief

³³ See Van Imhoff (1853, pp. 325–6) on losses in Coromandel.

³⁴ Feenstra Kuiper (1921, p. 102).

³⁵ It is not clear to us why Jacobs (2000, p. 119) states that during the eighteenth century 'the Japanese asked increasingly more taels for a pound of bar copper'.

³⁶ Van Imhoff, (1853, pp. 331–2). The price mentioned in the 1853 edition is actually 19:8:9, but this is based on an incorrect reading of the manuscript original. Glamann (1958, pp. 169ff.) reports the following prices per picul: 10 to 10.8 taels (c. 1623); 8 to 9 taels (c. 1646) and an offered price of 11.9 taels (1684). Van Imhoff (1853, p. 331) mentions a 10 to 13 tael range for the period around 1670.

³⁷ Feenstra Kuiper (1921, p. 135) mentions a price of 12.83 taels, which according to the accounts is not correct. See also Meylan (1833, pp. 175, 366).

³⁸ See Generale Missive 31 December 1745, where it is argued that the VOC should insist on 10,000 piculs at the 'ancient' price as a 'prerogative' and that a higher price for any additional copper might better be presented to the Japanese as a gift. *Generale Missiven*, Vol. XI, p. 254.

expenditure item was constant in terms of its unit of account, so there was no reason to adjust the tael conversion rate.³⁹

If correct, this would mean that for purposes of longitudinal study it is probably most helpful to convert all tael amounts for the eighteenth century at a constant rate. Because of the nearly fixed copper prices, this means in effect that the guilder equivalent of a tael revenue or cost item is expressed in a constant quantity of copper.

TREATMENT OF OVERHEAD COSTS

The last major accounting issue concerns the treatment of overhead costs, used here in the sense of all costs other than the cost of goods bought and sold. It may be recalled that since Glamann (1958), it has been recognized that the statements of gross profit margins by type of import good (*rendementen*) were a key item of management information to inform the VOC's commercial policy (see Jacobs, 2000, p. 218). For Japan, *rendementen* were calculated at least since 1686/87.⁴⁰ In keeping with this emphasis on gross margins, it was standard accounting practice, also followed in Japan, to transfer the balances of all cost accounts straight to the General Office account, so that the profit and loss account closed with the total gross profit on imports. This did not mean that these costs disappeared altogether. Every year the costs were extracted from the ledger and reported on the closing pages of each journal.⁴¹ These were summary statements in which costs were grouped under about a dozen headings (victuals, gifts, costs of merchandise, ships' repairs, general expenses, etc.) with comparative figures for the previous year for each item. It was therefore fairly simple to subtract these figures from the gross profits to arrive at a net profit. This was in fact done every year in the review reports prepared in Batavia on the basis of the accounts and in the general reviews of operations in Asia sent annually to the Netherlands.⁴² More recently, Feenstra

³⁹ Apart from an adjustment that would have been a logical consequence of the change in the unit of account itself, with the change from 'light' to 'heavy' money.

⁴⁰ Klein (1984, p. 198) notes that before 1746 the *rendementen* contained only raw data on individual sales transactions and doubts whether in that format they could have been of much use. However, we found that after 1686/87, the journals contain neat summaries of profit margin by product. It is not clear to us why the format adopted in the journal was not used for the *rendementen* as well unless, prior to 1746, the information in the journal was seen as the primary report on returns and the statements labelled *rendementen* were mere supporting documents. Klein also doubts whether the Japanese *rendementen* were actually used because he found no relation between margins and subsequent adjustments in the import mix. This overlooks the fact that the primary objective of imports was to satisfy Japanese demands for certain types of good and to generate sufficient revenues to acquire the copper. Losses on imports were a secondary consideration. (See, e.g., *Generale Missive* 31 December 1747, *Generale Missiven*, Vol. XI, p. 527).

⁴¹ This process was slightly complicated from 1749 onwards, when some costs were charged to the 'surcharge' on copper rather than to the General Office.

⁴² NA, Archief Factorij Japan, 1.04.21, Nos 674–681, 'Bevindingen op de Japanse negotieboeken', 1730/1–1805/6; *Generale Missiven*, *passim*.

Kuiper's (1921, Appendix III) tabulation of the factory's profits, reproduced in Figure 1, was prepared in the same way.

Controlling and reducing overhead costs was a perennial topic in the VOC, and the Japan factory was no exception. Van der Waeyen refers to an attempt in 1755 to set a limit of f112,000 to the overhead of the factory, which had been running as high as f172,000 in 1747/48 (to give a sense of proportion: gross profits were in the order of magnitude of f150,000–f400,000 during the 1730s and 1740s).⁴³ But, whereas these cost figures as reported in the accounts may have been useful for purposes of cost control, they did not cover the full costs of the Japan trade. The Deshima cost accounts recorded only the expenditure on the island and the consumption of victuals, equipment goods and gifts shipped in from Batavia. They did not record the wages of the Deshima staff, nor the cost of shipping between Batavia and Japan.

This way of recording costs was probably quite justifiable as a practical arrangement. Nevertheless, when considering the economic viability of particular activities, some kind of full costing would be required. There was awareness of this point in the VOC and therefore occasional reviews of specific activities were carried out in which some form of full-cost calculations were made 'according to merchants' manner' (Jacobs, 2000, p. 218). The Japan factory in the eighteenth century offers at least two examples of attempts to consider the total costs of the Japan trade.

The first example is found in Van der Waeyen's 1756 memorandum. As in his analysis of profits, he took his starting point in the accounts and calculated an average, based on ten years, of about f142,000 of costs per year. About half of this amount consisted of the costs of gifts and the annual journey to the court at Edo. This amount was adjusted for two items not included in the account. The first item consisted of the wages of the Deshima staff, which were paid in Holland, and which amounted to a modest f7,776 per year for a staff of twenty-one. More substantial was the cost of shipping of f65,900 a year. This was based on a fairly sophisticated calculation that might presumably merit the qualification 'according to merchants' manner'. The calculation was based on standard monthly rates for two different types of ship (125–145 feet and 145–150 feet) which were applied to the actual type of shipping over the last ten years to yield a total and an average annual cost figure. The rates included the sailors' pay, provisions for the voyage, an item 'for the wear and tear (*slijtage*) of the ship and the equipment' and an item for 'daily use'.

In passing, Van der Waeyen remarked that his calculations allowed a trade-off of the additional cost of sending three ships instead of two against the decreased risk of loss of cargo on what was considered to be a rather dangerous seaway.

Van der Waeyen's charge for 'wear and tear' makes up more than 40 per cent of total shipping costs, but as it is not explained there is no easy way to judge the reasonableness of the calculation. However, the resulting cost figures per unit-weight (*last*) of cargo are quite in line with similar calculations made in

⁴³ Strictly speaking, these are 'light' guilders, whereas Van der Waeyen's cost numbers are best read as 'heavy' guilders.

the late seventeenth century, and may therefore be accepted as a reasonable approximation.⁴⁴

The second example of charging the Japan trade with its full costs dates from 1769/70 when the calculations of profit margins in the *rendementen* were elaborated by charging each item with a percentage for overhead costs. Klein (1984, p. 201) hails this as 'an improvement in business administration of the highest order'. We can agree with respect to the sophistication with which the percentages were calculated, but we note that from some point prior to the 1740s onwards, merchandise shipped from Batavia to Japan already carried a charge of 2 per cent over original cost to cover general expenses. This charge was included in the accounts as part of the book value of the merchandise in Japan, and therefore reduced the reported gross margins. While this was clearly a rather rough-and-ready way of dealing with overheads, the calculations of 1769/70 and onwards were quite elaborate, perhaps even to the point of being fanciful. Gross margins were charged by itemized 'Expenses of Batavia' and 'Expenses of this Office', each expressed as a percentage of the cost of goods sold. The 'Expenses of Batavia' include percentages for 'Freight [from origin of goods] to Batavia', 'Risk at sea', 'Interest on capital advanced' and 'Administrative expenses'. The 'Expenses of this Office' include 'Expenses of ship and servants during the voyage from Batavia to Japan', 'Risk at sea', 'Interest on capital advanced', 'Administrative expenses' and 'Commissions [for the staff of the factory]'.

Different percentages for shipping, interest and risk at sea were applied to goods from the Netherlands and several different Asian stations. The variations in these percentages are not always obvious. While it seems logical enough to estimate shipping costs from the Netherlands (20 per cent) higher than from Coromandel (2.4 per cent), it is not immediately clear how the hefty 17.5 per cent for Ambon and the staggering 46.25 per cent for Macassar could be justified.⁴⁵ The 'risk at sea' of 5 per cent for voyages from the Netherlands compares awkwardly with the 7–9 per cent for Bengal, Coromandel and Surat. The chief feature of the overhead calculations, however, relates to the interest costs which are meticulously calculated in direct proportion to the number of months and even days that capital had been invested in each lot of, in all, several dozen commodities. While all of this is impressive in terms of the required clerical labour, it is not apparent that these percentages are a reliable guide to the actual costs. This is best shown by comparing the amounts for different costs according to the accounts, Van der Waeyen's memorandum and the calculations in the *rendementen*. Table 1 provides a comparison

⁴⁴ Gaastra (1989, pp. 177–86) discusses various contemporary estimates showing that the annual cost price per 'last' capacity was about f150–f200. Assuming that the Japan trade used ships of around 300 last (based on Van der Waeyen and on Gaastra, 1989, p. 168), and that these would be employed on the trade for seven months a year (Van der Waeyen), and taking the average for the period 1701–86 of 2.15 ships a year, the total annual cost would be between f56,400 and f75,250.

⁴⁵ The most likely explanation seems to be the comparatively low cost price of the spices produced by the VOC itself in the Spice Islands, which required high *ad valorem* surcharges to cover the costs of transport.

ABACUS

TABLE 1

ESTIMATES OF ANNUAL OVERHEAD COSTS, 1745/46–1754/55

Cost item	Average annual costs (guilders)		
	Accounts	Van der Waeyen	Rendementen ^a
Rent of Deshima	11,600	11,600	–
Victuals	23,921	23,921	–
Local and sundry ^b	17,651	17,651	–
Wages of staff	–	7,776	–
'Administration'	–	–	6,446
Gifts ^c	77,480	77,480	–
Bonuses ^d	31,551	31,551	16,116
Local ships' costs	3,474	3,474	–
Shipping: Batavia–Japan	–	65,896	20,951
Risk at sea Batavia–Japan	(average yearly loss of 0.2 ships)	–	38,678
Shipping of imports to Batavia ^e	–	–	48,348
Overhead Batavia ^f	6,446	6,446	9,666
Interest ^g	–	–	14,504
Total	172,123	245,795	154,709

^a 1769/70 percentages applied to 1745/46–1754/55 annual average value of imports.

^b Total of (extra)ordinaire ongelden, ongelden koopmanschappen, chianpans, timmeragie; nine-year average, missing data for 1754/55.

^c Total of schenkagiën and ongelden schenkagiën.

^d Nine-year average (missing data for 1751/52).

^e Including risk at sea, total percentage of 15 per cent, based on estimate of distribution over sending stations.

^f Surcharge of 2 per cent included in gross margin; augmented with 1 per cent in rendementen.

^g Based on average percentage of 9 per cent and a conservative estimate of time in stock of six months.

based on averages for the period 1745/46–1754/55.⁴⁶ The table shows how the three sources differ in terms of the costs included and in the amounts attached to them.

From Table 1 it is clear that none of the three sources dealt with all the possibly relevant costs. It is also clear that the rendementen understate total overheads even though they include cost items not included in the other two calculations. To some extent, this can be explained by the fact that the rendementen are concerned with imports only, so that it may be assumed that they implicitly leave some of the costs (e.g., about one-half of bonuses) to fall on the exports. Nevertheless, there seems to be no reason why such costly items as gifts should be completely left out of the calculations. Klein's (1984) conclusion that the rendementen showed how 'diseased and loss-making' the VOC's Japan trade really was should therefore have been even more negative if local costs had been taken more fully into account.

⁴⁶ This means that the percentages from the rendementen 1769/70 are applied retroactively. For some items averages are based on fewer than ten years.

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Despite the understatement of the total costs, however, the *rendementen* do recognize some cost items that appear to be relevant and that are not included in the other two approaches. Risk at sea, for instance, was not a negligible factor. The average loss of 0.2 ships a year applies roughly to the eighteenth century as a whole.⁴⁷ As the loss of cargo alone would amount to £150,000–£200,000 for each ship, estimating the structural expense at some £30,000 per year would not be excessive.⁴⁸

It is more difficult to assess the amounts for shipping goods to Batavia (prior to dispatch to Japan) and for interest. These items would clearly be relevant, if only because of the growing debts of the VOC during the eighteenth century. Yet it is difficult to be more concrete than to say that the 2 per cent overhead charge included on all imports must have been inadequate to cover these costs, if only because it would have been more than consumed by the costs of the voyage between Batavia and Japan.

As to accounting practices, the conclusion must be that the accounts probably give a reasonable view of the local overhead (apart from the complication of translation of local expenditure into guilders, and apart from wages, which turn out to be a rather minor item) but seriously underestimate the transport overhead because the 2 per cent charge is likely to be far too low.

ASSESSMENT OF PROFITABILITY

This section contains an attempt to arrive at an estimate on the combined effect on reported profits of the three accounting issues. This should not be seen as an attempt to estimate 'true' profits. As will be clear from the discussion above, the accounting issues facing the VOC were such that there was no single theoretically correct solution, either by contemporary or by modern standards. If nothing else, allocating costs to individual products or factories in an interconnected trade network would always have involved arbitrary choices. The purpose of this section is therefore to gain an understanding of the order of magnitude of the influence of accounting policy choice on reported profits, and hence of the margin of uncertainty surrounding data as shown in Figure 1.

In order to appreciate the numbers discussed in this section, it is helpful to have a frame of reference. The order of magnitude of the annual revenues, costs and profits of the Japan trade can be thought of as multiples of £100,000, with revenues, during the eighteenth century, fluctuating roughly between £500,000 and £1,000,000 and costs and profits as fractions of those amounts. These were substantial but not huge sums of money. They can be compared to the scale of the VOC as a whole, whose annual European sales revenues amounted to £15–20 million at mid-century, but whose annual (European) profits, if it did make profits, only

⁴⁷ Between 1701 and 1786, fifteen ships were lost on the Japan trade, or 0.17 every year.

⁴⁸ Based on the typical value of imports. A return cargo of copper would have roughly the same book value but presumably a rather higher market value.

rarely amounted to more than f2 million during the eighteenth century.⁴⁹ Another way to consider these figures is that, by the mid-18th century, an amount of f1–1.5 million might equal the total revenues of one of the seven provinces (other than Holland) making up the federal Dutch republic.⁵⁰

This section takes as its starting point the extracts from the Japanese account books recorded in Feenstra Kuiper (1921, Appendix III). These show, year by year, the key figures such as sales revenue, costs of goods sold and total other costs, compiled from the account books of the factory. It is worthwhile to make explicit the underlying assumption that these figures can be accepted at face value. Given the VOC's persistent reputation for fraud and corruption, this is not self-evident. The VOC did have certain routine procedures for auditing the account books of its factories, but an investigation of these procedures is beyond the scope of this article. With this caveat, Figure 1 serves as a graphical representation of our starting point.

Currency Translation

As argued above, a longitudinal analysis of the VOC's Japan profits is best served by expressing all guilder amounts in the 'heavy' guilders of 1768, and by translating all tael amounts by a constant rate relative to this guilder. When this approach is applied to the costs and revenues making up the gross margins on imports, the effect is quite dramatic (Figure 2). Instead of a secular decline, the figures actually show a certain improvement during the second half of the century. This result is quite predictable, as the historical figures for the early part of the century were based both on a high tael rate and were expressed in 'light' guilders.

When moving beyond gross margin, the profits on copper and the overhead costs, discussed more fully below, have to be based on constant currency values as well. For the copper profits, this is not too difficult and mainly an issue of making sure that assumed resale prices are expressed in constant guilder terms. For the local overheads, this is slightly more complicated as these have to be divided into a guilder component and a tael component. In the 1748/49 ledger, we found that costs expressed in tael (rent for the island, wages of porters, locally acquired victuals, etc.) amounted to 30 per cent of total recorded overhead and we assume that a similar proportion prevailed throughout the century.

Profits on Copper

The recorded profits need to be adjusted on two counts to take into account the profits of copper. First, it should be recalled that from 1749 onwards, a 'surcharge' on copper was added to the profits of the factory. This should be deducted and replaced, for the entire period, by a credit for the value of the copper based on a more realistic assessment of its value. Such a value should preferably be the value on delivery in Batavia, in order to avoid the complications of the different resale

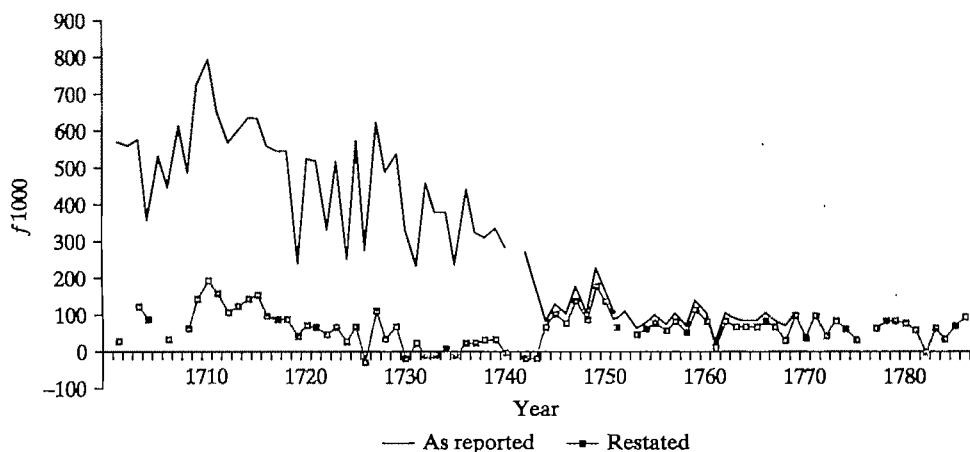
⁴⁹ Steur (1984, p. 232); cf. Gastra (1989, pp. 280–1).

⁵⁰ See Fritschy (1996) for Overijssel and Van den Ent and Enthoven (2001) for Groningen.

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FIGURE 2

GROSS MARGIN ON IMPORTS RESTATED FOR CURRENCY CONVERSION



Source: Feenstra Kuiper (1921, Appendix III). Sales revenues restated in taels at historical rates (compiled by authors) and reconverted to 'heavy' guilders at the 1768 guilder/tael rate. Costs of goods sold restated in 'heavy' (1768) guilders.

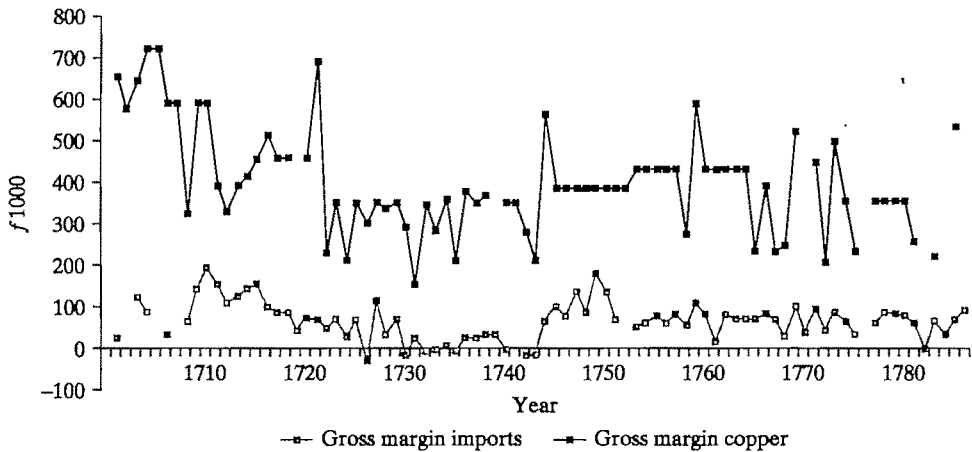
prices and costs of the various factories on the Indian subcontinent. Unfortunately, there are no readily available records of such values. What we do have are resale prices in India between 1746 and 1755 ranging between $f57$ and $f109$ per picul and an estimate of average resale prices for the period 1759–68 of $f85.60$.⁵¹ In addition, there is a note by Meylan (1833, pp. 200–1) that the VOC in Batavia was prepared to buy small quantities of copper that were allowed as a traditional privilege to the chief factors of Deshima, and that it did so at a price of $f60$ per picul. As an estimate of the value of the copper delivered to Batavia, an average of $f60$ per picul might therefore be a reasonable first approximation. Figure 3 shows gross margins on copper calculated in this way, expressed in constant guilders and combined with the gross margin on imports already shown in Figure 2. Based on a price of $f60$ per picul, it is clear that it was indeed copper that contributed most to the profitability of the Japan trade.

Figure 3 shows that gross margins, in total, are fairly constant over the century, but this is of course a direct result of the assumption of a fixed resale value. With this assumption, fluctuations in the gross margin on copper are almost entirely due to fluctuations in the quantity of copper as the purchase price remained nearly constant at $f18$ – 20 per picul. It is therefore easy to see that the gross margins in Figure 3 would move up and down in direct proportion with the assumed resale value of the copper, and margins would be halved if a more conservative resale

⁵¹ According to Van der Waeyen, as discussed above, and Van der Oudermeulen, cited in Steur (1984, p. 231).

FIGURE 3

GROSS MARGINS (CONSTANT CURRENCY)



Source: Feenstra Kuiper (1921, Appendix II and III). Gross margin on imports as in Figure 2. Margin on copper based on actual quantities, multiplied by the difference of (a) a fixed resale value of f 60,- (assumed 'heavy') and (b) historical purchase price in taels, converted at 1768 guilder/tael rate.

value of f40 were to be assumed. In general, it is known that copper prices in India began to be fall from about 1760 onwards because of increasing supplies of copper from other sources (Jacobs, 2000, p. 119), and it is therefore possible that the trend of margins shown in Figure 3 should be shifted somewhat in favour of the pre-1760 period.

Overhead Costs

The final step in restating the accounting figures is to consider overhead costs. Apart from restating recorded amounts in constant guilders, this requires estimates of the 'external' overheads not recorded in the Deshima accounts. Following Table 1, estimates of the following costs need to be added to the recorded costs (all in 1768 guilders):

- Wages of staff: based on Van der Waeyen's memorandum, these can be set at f8,000 a year.⁵²
- Costs of shipping Batavia–Japan: as Van der Waeyen's data appear to be quite reasonable (see above), these are assumed to be f65,000 per year.
- Sea risk Batavia–Japan: as estimated above, f30,000 per year.
- Costs of imports 'off Batavia': on this point we have only the percentages in the rendementen to guide us, which state the costs of collecting import goods in

⁵² A comparable amount relating to the 1760s is found in a 1772 memorandum by VOC director Van der Oudermeulen (cited in Steur, 1984, p. 231).

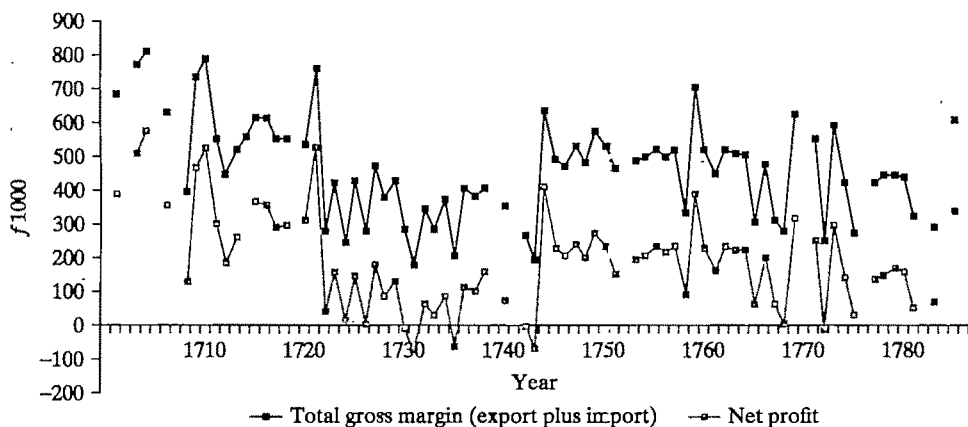
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Batavia at about 15 per cent of their invoice value (see notes to Table 1). This figure may not be unreasonably high, as the resulting money amount is typically lower than the shipping costs Batavia-Japan. Fifteen per cent is also fairly low when compared with cost figures available on other intra-Asian routes.⁵³ Choosing a higher figure would not greatly alter the conclusions of this study, however.⁵⁴

The sum of recorded, restated and estimated overheads is shown with the gross margin data on imports and copper in Figure 4, which is therefore a rough estimate of the net profits of the Japan factory. Based on Figure 4, a number of conclusions can be drawn. The first is that overheads were really substantial compared to gross margins, and that they therefore have to be taken into account in any discussion of the factory's profitability. Figure 4 also appears to show that, despite substantial overheads, the Japan factory was in fact profitable for most of the eighteenth century. Although the first two decades still seem to have been the best, there seems to have been a recovery of some kind in the 1740s that lasted until after 1770. If these figures are accepted, the average annual profit of about f190,000

FIGURE 4

TOTAL GROSS MARGIN AND NET PROFIT (CONSTANT CURRENCY)



Total gross margin is sum of margins on imports and exports as in Figure 3. Net profit is total gross margin minus overheads. Overheads are the sum of local and external overheads. Local overheads as reported in Feenstra Kuiper (1921, Table III), restated in 1768 guilders after restating estimated tael component (30 per cent) at constant guilder/tael rate. Estimation of external overhead as discussed in the text.

⁵³ Steur (1984, pp. 228–9) has eighteenth-century data on routes from Batavia to the Indian subcontinent which disclose *ad valorem* percentages of up to 25 per cent. The main problem with all data of this type is the huge disparity in the value per unit of weight of the goods carried by the VOC.

⁵⁴ Using 25 per cent would decrease average annual profits from f190,000 to f160,000.

would have been an important contribution to the VOC's profits. Needless to say, Figure 4 is based on a number of crucial assumptions. In particular, assuming a lower value of copper for the period following 1760 would affect the general trend in profits. However, the 'off Batavia' value would have to fall to about f40 before the factory would be making a small structural loss.

On balance, though, the conclusion seems justified that the decline in profitability was not nearly as pronounced as the accounts would suggest. In addition, it seems correct to conclude that the decision to keep the factory open, even if it was in fact taken for different reasons, did not run counter to the commercial interests of the VOC.

CONCLUSIONS

In this article, we have analysed the accounting practices of the VOC's Japan factory in the light of the ongoing debate on the factory's profitability. The factory's profitability was already questioned during the eighteenth century and it was recognized that profits as shown by the factory's accounts might not properly reflect the contribution made by the Japan trade. We conclude that contemporaries and subsequent historians have addressed at one stage or another each of the three main accounting issues facing the factory, viz., the transfer price recorded for copper exports from Japan, the translation of Japanese currency into the unit of account and the allocation of overhead costs to the factory. However, the joint effect of these issues on accounting profits has so far not been investigated. Our analysis of accounting practices has considered all three points in order to arrive at well-founded approaches to adjusting the accounting figures in a way that better reflects the underlying economics of the factory.

After these adjustments, the figures suggest that the VOC was justified, from a commercial point of view, to keep the factory open, even though the formal accounts showed a strong decline in profits. We believe that the general principles of adjusting the figures as used in this article will be helpful in future historical research into the VOC's Japan trade. Such research should be focused on improving on the key assumptions of costs and prices in order to arrive at more accurate estimates.

As a secondary conclusion, our research confirms conclusions of earlier researchers (e.g., Gaastra, 1989) that at least some VOC officials had a quite sophisticated understanding of their own accounting systems and were capable of supplementing them with both *ad hoc* and regular calculations outside the account books.

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JIM PSAROS AND KEN T. TROTMAN

The Impact of the Type of Accounting Standards on Preparers' Judgments

This article examines preparers' consolidation judgments and how they are impacted by the precision of accounting standards (substance-over-form versus rules-based). The examination is performed via two laboratory experiments in a consolidated accounting setting. In Experiment 1 it was found that when subjects used a substance-over-form accounting standard they justified their consolidation judgments on case specific information rather than on different interpretations of the phrase 'capacity to control'. In Experiment 2 it was found that when subjects used a rules-based standard, incentives were found to impact on accountants' consolidation judgments and more aggressive judgments were made through their assessments of case specific information. Comparison of the judgments made in Experiment 1 with one of the treatment groups in Experiment 2 enabled a comparison to be made of consolidation judgments of subjects under both substance-over-form and rules-based accounting standards. While both groups had the same incentive not to consolidate, marginally significantly more subjects using the rules-based standard did not consolidate than subjects using the substance-over-form standard. This finding is contrary to anecdotal claims that the imprecision of substance-over-form standards may be less effective in stopping biased financial reporting than rules-based standards.

Key words: Accounts; Consolidation; Judgment; Standards; Substance-over-form.

Some accounting standards are very specific in their wording and very direct in their requirements of account preparers (i.e., rules-based), yet other standards are more general in their wording and guidance to users (i.e., substance-over-form or principles-based). Following the recent spate of corporate failures both in Australia and overseas there has been renewed debate on the appropriate precision of accounting standards. This raises the question of which type of standard is likely to be more effective and how different types of standards impact on the judgments of preparers of financial statements.

While the U.S.A. has traditionally adopted a rules-based approach, the Financial Accounting Standards Board (FASB), reacting in part to anger generated by the collapse of Enron, has recently asked for public comment on a potential move to a

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substance-over-form (principles-based) approach (Norris, 2002). In addition, in the U.S.A. Section 108(d) of the Sarbanes-Oxley Act of 2002 directed the SEC to conduct a study on the adoption by the U.S. financial reporting system of a principles-based standard setting process and to submit it to Congress. This mandate was fulfilled by a recent SEC Study (SEC, 2003).

While the substance-over-form terminology can be traced to at least the late 1920s (Clarke and Dean, 1992) it has gained increased impetus more recently. Accounting standard setting bodies in Australia and the U.K. have placed much faith on substance-over-form as an appropriate future direction for standard setting. For example, the Australian Accounting Research Foundation has placed substantial reliance on substance-over-form as a key criterion in accounting standards indicating, that a pervading theme of all future accounting standards would be to reflect the economic substance of financial information over its legal form (McGregor, 1994). In response to the recent corporate collapses in Australia there have been frequent reports in the recent financial press of the preference for a principles-based approach over a rules-based approach by both business lenders and politicians.¹ For example, the Prime Minister, John Howard, in response to calls for increased regulation cited Australia's principles-based approach to accounting standards rather than the U.S. rules-based approach which could encourage avoidance and a 'show me where it says you can't do it attitude' (*Australian Financial Review*, 23 December 2002).

Support for a substance-over-form approach to accounting standards has not been confined to Australia. Explicit and implicit support for the substance-over-form approach has come from prominent standard setters, academics and practitioners in the U.K. (Tweedie, 1991), Europe (Hegarty, 1995), the U.S.A. (Roussey, 1995) and Canada (Gibbins and Mason, 1988). Most recently SEC (2003) concluded that those involved in the U.S. standard setting process should more consistently develop standards on a principles-based approach. However, others have been concerned that the imprecision of such standards might lead to abuse by account preparers by providing an avenue for accountants to produce biased accounts (Godfrey, 1990; cited in Clarke and Dean, 1992, 1993; Henry, 1999).

In spite of the debates over the appropriateness of rules-based and substance-over-form standards, we know very little about accountants' judgments under these two types of standards. Consequently, the main purpose of this study is to examine the impact of accounting standards on the judgments of very experienced preparers via two laboratory experiments in a consolidated accounting setting. The study addresses the following specific research questions: Do preparers vary their interpretation of substance-over-form accounting standards and case specific information depending on their reporting recommendation? What impact does the type of

¹ Examples include the following *Australian Financial Review* articles: Fiona Buffini, 'PM Puts CEOs on Notice', 7 August 2002; Bill Pheasant, 'Coonan in Accord on Corporate Regulation', 13 August 2002; Bill Pheasant, 'Business Resists Governance by Black-Letter Law', 15 August 2002; Alessandra Fabro and Fiona Buffini, 'Corporate Shake-Up Hits Accountants', 15 September 2002; Andrew Clark, 'Regulating the Regulators', 23 September 2002.

standard (substance-over-form versus rules-based) have on accountants' consolidation judgments? Are the consolidation judgments and interpretations of case specific information that accountants make when using a rules-based accounting standard influenced by incentives? Does the stringency of a rules-based accounting standard impact consolidation recommendations? This is also the first examination of the judgments of a particular group of managers, namely, preparers of accounting reports. These preparers regularly make numerous important judgments affecting reported earnings and their judgments appear to have been neglected by the judgment and decision making literature in accounting. This is somewhat surprising given the extensive literature on auditor judgments (see reviews by Libby and Luft, 1993; Libby, 1995; Solomon and Shields, 1995; and Trotman, 1996) and some research on the users of accounting reports (see review by Maines, 1995).

BACKGROUND LITERATURE

To put things in a historical perspective, it should be noted that previous major corporate collapses have similarly been accompanied by criticisms and calls for regulatory reform of existing accounting and auditing practices (Clarke and Dean, 1992). These suggestions include the need for tighter accounting standards and more fundamental changes such as calls for accounting 'to tell it how it is', including a move to market prices (e.g., Chambers and Wolnizer, 1990; Clarke and Dean, 1992) and warnings that 'the financial reporting and corporate regulatory system grinds on within the same accounting groove, almost guaranteeing that in due course history will be repeated again' (Clarke and Dean, 1992, p. 186). Clarke and Dean note that despite the accounting defects of the 1980s the accounting profession has retained the maintenance of essentially a historical cost-based framework qualified by the preparation of accounts on the basis of substance-over-form of the particular transaction.

Under a substance-over-form approach, accounting standards contain relatively few rules. They are documents of broad principle, which rely on the user of the standard to apply principles and professional judgement in respect of the accounting issue at hand. The intention of the standard should be paramount in the eyes of the user. In contrast, a rules-based approach requires the user of the accounting standard to follow more detailed and specific rules in determining the correct accounting treatment for a transaction or event. With respect to what constitutes control for consolidation, accounting standard setters in Australia, Canada and the United Kingdom have adopted a substance-over-form approach with definitions of control revolving around the capacity to dominate decision making.

There has been very limited research on the impact of different types of standards on the judgments of professional accountants (Libby *et al.*, 2002). One exception is Cuccia *et al.* (1995) who suggest that standards that use more stringent language and increased precision are not necessarily more effective in mitigating aggressive reporting than standards that contain vague language. In an experimental setting, Cuccia *et al.* investigated whether replacing a tax standard that employs a vague,

verbal disclosure threshold with a standard that employs a more stringent numerical threshold mitigates aggressive reporting decisions by taxation practitioners. They found that the reporting decisions were equally aggressive under either standard.

Other research on how managers' and auditors' incentives and financial accounting regulations determine how they report events is also relevant to the research questions addressed in this article (see Libby *et al.*, 2002, for a detailed review). Using the Libby *et al.* (2002) framework, we first consider the largest group of experimental earnings management studies which focus on auditors' incentives. One such group of studies indicates that auditors are more likely to allow aggressive accounting positions by the clients when the related evidence or precedents offer more room for interpretation. Nelson and Kinney (1997) examine the influence of uncertainty about the probability that a future loss will occur on auditors' and users' judgments. They show that auditors are more (less) conservative than users when the relevant evidence was precise (ambiguous). Salterio and Koonce (1997) in their examination of auditors' treatments of clients' capitalization versus deferral decisions found that when precedents favoured one alternative, auditors followed precedents, but when precedents were mixed, auditors were more likely to follow their client's preference. In an experimental economics study, Mayhew *et al.* (2000) found that auditors tended to misreport in favour of their clients as their uncertainty about the appropriate disclosure increased. Hackenbrack and Nelson (1996) varied auditors' incentives and found that auditors are more likely to allow their clients to take aggressive accounting positions if the auditors' litigation risk is reduced. In addition, they found that auditors justify the aggressive position with aggressive interpretations of the relevant accounting regulations.

A few studies have also examined how managers' incentives affect the aggressiveness of their reporting decisions. For example, Nelson *et al.* (2000) elicited from Big 5 audit partners and managers their experiences with clients who they believed attempted earnings management (AEM). They identified the relative frequency with which AEMs occur in various accounts, the frequency with which they are waived by auditors and what factors affect auditors' decisions to waive the AEMs including factors like financial accounting standard precision. Their results indicate that income increasing AEMs are more likely when transactions have been structured and/or standards are precise.

OVERVIEW OF THE EXPERIMENTS

To address the research questions noted earlier, two experiments were conducted, allowing us to use data from Experiment 1 in the construction of the research instrument in Experiment 2. Experiment 1 focuses on the consolidation judgments that accountants make when using a substance-over-form accounting standard (i.e., AASB 1024, 1992, *Consolidated Accounts*). It examines the relationship between reporting recommendations and preparers' assessment of case specific information and accounting standards in a consolidation setting. In addition, in order to create a benchmark for the drafting of a hypothetical standard in Experiment 2, Experiment 1 obtains subjects' perceptions of the stringency of AASB 1024.

In Experiment 2, where a rules-based standard is used, the impact of preparer incentives on the consolidation judgement is also examined. A further objective of Experiment 2 is to examine the relationship between reporting recommendations and preparers' assessments of case specific information. Comparisons are made between specific judgments in Experiments 1 and 2 to provide a comparison of the consolidation judgments under the two types of accounting standards.

Both experiments required the judgments of senior accountants who were likely to play a part in the financial reporting decisions of their organizations. Accordingly, a solicitation letter was sent to the 'Chief Financial Accountant' of 1,278 companies listed on the Australian Stock Exchange. The solicitation letter requested the chief financial accountant to participate in a research study. There were several advantages in sending a solicitation letter seeking participation rather than sending out the research instrument to all companies. First, the instrument is relatively lengthy and requires close analysis. There was a risk that sending an uninvited, lengthy and complex instrument would have resulted in a low response rate. Second, it was felt that by obtaining approval to send the instrument the chance of obtaining considered and quality judgments increased. Third, in the reply where subjects indicated that they would participate in the project, they provided details including years of accounting experience and their position in their organization. This information, coupled with the knowledge of which companies would respond, meant that some variables (accounting experience, position in organization, company size and industry sector) could be matched between the pilot study, Experiment 1 and Experiment 2 prior to randomly allocating subjects.

Replies were received from 345 respondents who indicated they were willing to participate. Twenty were sent the pilot test, 81 received Experiment 1, 163 received Experiment 2 and 81 were used in another study not reported here.² Results of the pilot study for Experiment 1 were encouraging, with a reasonably good response rate of 16 (80 per cent). It appeared that respondents did not have any problems understanding the judgment task. Therefore, other than some minor cosmetic changes, the research instrument remained unchanged. There were 58 responses (72 per cent) to Experiment 1 and 121 (74 per cent) responses to Experiment 2. Table 1 indicates that the majority of participants held senior positions in their organization and had a significant amount of accounting experience.

EXPERIMENT 1

Hypothesis Development

Justification has been shown to be very important in accountants' judgments (Gibbins and Emby, 1985; Gibbins and Newton, 1994). These justifications are likely to be affected by incentives. For example, Hackenbrack and Nelson (1996) found that auditors justified their aggressive reporting by applying vague disclosure

² Originally 162 subjects were used in Experiment 1 with 81 receiving an incentive not to consolidate treatment (results reported here) and another 81 receiving no information on incentives. This latter group is not included in this article as we have no information on their default assumption.

ACCOUNTING STANDARDS AND PREPARERS' JUDGMENTS

TABLE 1

SUMMARY DATA ON SUBJECTS AND THEIR COMPANIES

	Experiment 1	Experiment 2	Pilot	Total
Accounting experience				
Years (mean)	17.4	17.3	17.4	17.3
Title				
Financial controller/Director	28	54	8	90
Company sec./Managing director	13	29	5	47
Company accountant	8	20	1	29
Accountant	7	15	2	24
Other	<u>2</u>	<u>3</u>	<u>0</u>	<u>5</u>
Total	<u>58</u>	<u>121</u>	<u>16</u>	<u>195</u>
Company size				
Top 100 company	10	19	2	31
Non-top 100 company	<u>48</u>	<u>102</u>	<u>14</u>	<u>164</u>
Total	<u>58</u>	<u>121</u>	<u>16</u>	<u>195</u>

criteria used in accounting standards. We suggest that, in an accounting setting, the aggressive reporting recommendation will be reflected in a corresponding 'aggressive' interpretation of either an accounting standard or case specific information (or both). For example, the accountant may take an extreme interpretation of an accounting standard to justify the aggressive reporting recommendation. This can be achieved by exploiting the discretion that exists in a key definitional term in an accounting standard to support his/her preferred reporting position. In Hackenbrack and Nelson (1996) auditors justified their aggressive positions with aggressive interpretations of the relevant financial accounting regulations. In the context of AASB 1024, the accountant may place an extreme interpretation (either excessively broad or narrow—as suits the preferred reporting position) on the meaning of the phrase 'capacity to control'.

Alternatively, while the accountant may make a reasonable interpretation of an accounting standard, they may justify an aggressive reporting disclosure on the basis of an extreme assessment of case specific information. For example, Cuccia *et al.* (1995) found that when a numerical standard is in place, tax practitioners use the latitude available in assessing evidential support to justify an aggressive reporting decision. In the context of AASB 1024, notwithstanding that the accountant may place a reasonable interpretation of the meaning of the phrase 'capacity to control', they may claim that a specific set of circumstances is not caught by the standard. This suggests the following hypotheses.

- H1a Accountants who make aggressive reporting recommendations are more likely to assess accounting standards aggressively than accountants who do not make aggressive reporting recommendations.

- H1b Accountants who make aggressive reporting recommendations are more likely to assess case specific information aggressively than accountants who do not make aggressive reporting recommendations.

In the context of this study, consistent with the definition of Cuccia *et al.* (1995), an 'aggressive' reporting recommendation is deemed to be one where the accountant selects the reporting disclosure that portrays events favourably when that position is not indicated clearly by the facts and the relevant professional literature. In this study an aggressive reporting recommendation will result in non-consolidation as the investee company returned a material loss. Assessing an accounting standard aggressively will result in a high AASB 1024 score and assessing case specific information aggressively will result in a low case score.

Method

Research Instrument Subjects were sent via mail a research instrument which contained three components: a company description, an accounting scenario and a summarized version of AASB 1024. In the company description all subjects were asked to presume that they were the financial controller of a company (Dunball Electrical) which had acquired a stake in another company (Tonens Finance) during the previous twelve months. During the year, Tonens Finance made a loss of \$7.3 million. Subjects were provided with two sets of summarized financial statements. One set was prepared on the assumption that consolidation occurs. The other set was prepared on the assumption that consolidation does not occur, but supplementary equity accounting information is provided.

All subjects received the same company description, including Dunball Electrical's senior management preference to show an aggressive position in their financial statements and adopt an aggressive, yet legitimate, posture in the resolution of grey areas of accounting. They were also told that during the next financial year Dunball Electrical intends to raise funds by way of a share float. Therefore, subjects were provided with an incentive *not* to recommend consolidation, that is, a preference not to consolidate the material loss.

The accounting scenario, which formed the second part of the research instrument, contained the following information cues:

- An investee company (Tonens Finance) has eleven members on its board of directors. Five of the members are senior management of an investor company (Dunball Electrical).
- Dunball Electrical owns 33 per cent of Tonens' voting shares. The remaining shares are held by a wide range of investors.
- An arrangement exists which gives Dunball the right to approve Tonens' future borrowings and terms of operations.³

³ Based on previous research carried out by one of the researchers (Day and Psaros, 1996), it was a borderline case; when asked for a numeric assessment (out of 100) of the likelihood that consolidation should occur the mean score for the scenario was 54.03, standard deviation 39.37, median score 67, and a range from 0 to 100. In addition, 55.4 per cent of subjects assigned a score of 50 or greater and 44.6 per cent of subjects assigned a score of less than 50.

ACCOUNTING STANDARDS AND PREPARERS' JUDGMENTS

The third part of the research instrument was a summarized three-page version⁴ of accounting standard AASB 1024. This summarized standard contained all the sections, which related directly to the core consolidation judgment.

Research Design Subjects all received the same information in this treatment in Experiment 1 reported here. The testing of H1a and H1b is based on the relationship of the three judgments (dependent variables) made. Subjects were required to provide a response to each of the following dependent variables. The sequence of the dependent variables was randomized in the research instrument.

1. *Consolidation Reporting Decision*—subjects indicated whether they would recommend to senior management that consolidated accounts be prepared (yes or no).
2. *Interpretation of Accounting Standard Stringency*—subjects were asked, in the practical application of AASB 1024, what should be the *minimum* probability that one company has the *capacity to control* another company before consolidated accounts are prepared (to test H1a and to create a benchmark for the drafting of the hypothetical accounting standard used in Experiment 2).
3. *Assessment of Case Specific Information*—based upon the specific information provided in the case, subjects estimated the probability (percentage amount) that Dunball (an investor company) has the capacity to control Tonens (an investee company) (to test H1b).

Results

As shown in Table 2, the percentage of subjects recommending consolidate/not consolidate is 56.9/43.1. Recall that in this case an aggressive reporting recommendation will result in a recommendation to not consolidate.

TABLE 2
REPORTING RECOMMENDATIONS—EXPERIMENT 1

Subjects	Recommend consolidation	Not recommend consolidation	Significance level: $p =$
Recommendation	33 (56.9%)	25 (43.1%)	
Interpretation of 'capacity to control'	$M = 59.22$ $SD = 16.13$	$M = 60.92$ $SD = 17.01$	$t = 0.383$ $p = 0.352$
Probability estimates of whether investor company had the capacity to control the investee company	$M = 78.69$ $SD = 13.19$	$M = 53.28$ $SD = 13.08$	$t = -7.249$ $p = 0.001$

⁴ One possibility was to send a full copy of AASB 1024 to each subject. However, the standard is over thirty pages in length and contains guidance on many issues which do not impact on the consolidation judgment. It was felt that the bulkiness of the standard might have been a disincentive for subjects to complete the task or perhaps hinder them from focusing on key sections of the standard.

There was no significant difference in the numeric interpretation of the phrase 'capacity to control' in AASB 1024 between consolidating and non-consolidating subjects. Consolidating subjects assigned a mean score of 59.2 to 'capacity to control', compared to non-consolidating subjects who assigned a mean score of 60.9 ($t = 0.38$, $p = 0.35$, one-tailed). These results do not support H1a.

To test H1b a comparison was made of subjects' probability estimates of whether the investor company had the capacity to control the investee company. Given that assessing case specific information aggressively will result in a *low* case score, evidence supporting H1b was found. Subjects who recommended non-consolidation made a more aggressive interpretation of the case specific information ($M = 57.3$) than subjects who recommended consolidation ($M = 78.7$) ($t = -7.25$, $p = 0.001$).

EXPERIMENT 2

In Experiment 2, consolidated judgments in the context of a rules-based standard were examined. The rules-based standard uses more precise language, provides a list of factors which are 'evidence of control' and provides a specific percentage benchmark. In addition, the impact of incentives on consolidation judgments is examined in the context of this rules-based standard. The incentives variable was manipulated on the basis of the financial performance of the investee company. A comparison of the manipulations between Experiments 1 and 2 is provided in Table 3.

Hypothesis Development

Libby *et al.* (2002) summarize the relevant research on how managers' and auditors' incentives and financial accounting regulations determine how they report events.

TABLE 3
COMPARISON OF MANIPULATIONS: EXPERIMENT 1 AND EXPERIMENT 2

Experiment 1	Experiment 2
1. Investee company returned <i>material loss</i>	<i>Loss group (incentive not to consolidate)</i>
2. <i>Share float</i> during next financial year	1. Investee company returned <i>material loss</i>
3. Management prefer to adopt an <i>aggressive</i> posture in respect of accounting disclosures	2. <i>Share float</i> during next financial year
4. Substance-over-form standard	3. Management prefer to adopt an <i>aggressive</i> posture in respect of accounting disclosures
	4. Rules-based standard
	<i>Profit group (incentive to consolidate)</i>
	1. Investee company returned <i>material profit</i>
	2. <i>Share float</i> during next financial year
	3. Management prefer to adopt an <i>aggressive</i> posture in respect of accounting disclosures
	4. Rules-based standard

They suggest, not surprisingly, that the empirical research provides evidence that managers and auditors use the flexibility in accounting rules to make disclosures favoured by their incentives. Further, they suggest that when holding constant the amount of flexibility (e.g., not varying the standard), changes in incentives will move disclosure in the direction favoured by those incentives. While there has been no empirical evidence on preparers, the above arguments would suggest:

- H2 When using a rules-based accounting standard, accountants with incentives to not recommend consolidation are less likely to recommend consolidation than accountants who have incentives to recommend consolidation.

Furthermore, Libby *et al.* (2002) suggest that when holding the incentives constant, any increase in flexibility (e.g., more or less stringent probability thresholds) would increase the degree to which incentives affect decisions. One exception is provided by Cuccia *et al.* (1995), who found that tax professionals were not affected by the stringency of the standard but instead found that subjects more liberally interpreted the case material to support their preferred reporting position. However, it is not clear whether the Cuccia *et al.* findings would apply in this financial accounting setting as tax professionals' incentives and work standards are likely to be different. Also their tax case provided a lot of flexibility in interpreting evidence and therefore the increase in stringency did not necessarily create a sufficient decrease in flexibility to affect decisions materially. To examine these issues in a consolidation setting two versions of the rules-based accounting standard were used. The two versions varied the probability threshold for an entity to be considered under the control of the parent organization. This was varied between 51 per cent and 70 per cent. It is to be expected that a 51 per cent threshold would be regarded as more or less 'stringent' than a 70 per cent threshold depending upon the perspective of the account preparer. For example, if the preparer of the accounts preferred to *exclude* an entity from the consolidated accounts (e.g., loss making entity) then the preparer may regard a 51 per cent threshold as more stringent than a 70 per cent threshold. Conversely, if the preparer of the accounts preferred to *include* an entity in the consolidated accounts (e.g., profit making entity) then the preparer may regard a 70 per cent threshold as more stringent than a 51 per cent threshold. Examining these issues for consolidated judgments of preparers under a rules-based standard, the following hypotheses are tested:

- H3 The consolidation recommendations of accountants will be affected by the stringency of the standard measured by the probability threshold presented.
- H4 Accountants with incentives to recommend consolidation are more likely to assess case specific information aggressively than accountants who have incentives not to recommend consolidation.

Hypothesis 5 compares some of the data from Experiment 1 with data in Experiment 2 to examine the impact of the different types of accounting standards on preparer judgments. While there have been suggestions that the use of rules-based standards would lead to less aggressive reporting decisions (e.g., Knapp, 1985; Godfrey, 1990), these suggestions are not supported by recent empirical evidence

on how changes in regulations or other interventions affect reporting decisions. For example, Hirst and Hopkins (1998), Libby and Kinney (2000) and Maines and McDaniel (2000) provide empirical evidence of recent regulatory changes that do not appear to prevent managers from making reporting decisions that portray them more favourably. Cuccia *et al.* (1995) provide evidence that even when a tax practice standard was made more stringent, the impact of the incentive was still sufficient to make subjects report aggressively. Based on their two experiments in aggregate, Cuccia *et al.* conclude that when a vague standard is in place, tax practitioners use the latitude inherent in the standard to support aggressive reporting decisions. However, even when a more stringent numeric-threshold standard is in place, tax practitioners will still make aggressive reporting decisions by shifting their assessment of evidential support to justify the reporting decisions. For the preparers in the present experiment, this would suggest no difference in the aggressiveness of consolidation recommendations between the two types of standards.

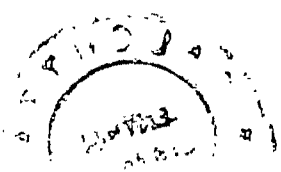
H5 Consolidation judgments made under a rules-based standard will not reduce the aggressiveness of preparer judgments compared to those made under a substance-over-form accounting standard.

Method

Research Design In an endeavor to test whether account preparers' consolidation judgments are different under substance-over-form standards from those made under rules-based standards, a hypothetical accounting standard, Accounting Standard RB Consolidated Accounts (RB Std) was drafted. It was drafted with the specific intention of making it as similar as possible to AASB 1024, but more rules-based in nature. In a practical sense, accounting standards can rarely be described as *absolutely* rules-based or *absolutely* substance-over-form. Thus while RB Std cannot be described as completely rules-based, its consolidation requirements are defined in more precise terms than AASB 1024. Further, RB Std provides a specific percentage benchmark for the consolidation judgment and factors which are 'evidence of control'.

There were two independent variables manipulated in a 2×2 between-subjects design. These were the financial performance of the investee company and the probability threshold specified in the accounting standard. The first independent variable was the financial performance of the investee company. Half of the subjects (the Profit group) were told that during the current financial year Tonens returned a profit of \$7.3 million. It was felt that subjects assigned to the Profit group had incentives to recommend consolidation of the profitable investee company given management preferences and the forthcoming share float. The remaining subjects (the Loss group) were told that during the current financial year Tonens returned a loss of \$7.3 million. Thus, it was felt that subjects assigned to the Loss group had incentives to not recommend consolidation of the loss-making investee company, again given management preferences and the forthcoming share float.

The second independent variable was the probability threshold specified in Accounting Standard RB Consolidated Accounts. As discussed previously, two



probability thresholds were specified—51 per cent and 70 per cent. Fifty-one per cent was selected because it was the median probability threshold assigned to AASB 1024 by Experiment 1 subjects. This was therefore presumed to be a reasonable quantitative estimate of the stringency of AASB 1024. Seventy per cent was selected subjectively as a threshold so that judgments could be compared across different percentage thresholds.

Subjects were randomly allocated into one of four treatments: Profit RB Std 51, Profit RB Std 70, Loss RB Std 51 and Loss RB Std 70. Subjects were asked to respond to the following dependent variables:

1. *Consolidation Reporting Decision*—subjects indicated whether they would recommend to senior management that consolidated accounts be prepared.
2. *Assessment of Case Specific Information*—based upon the specific information provided in the case, subjects estimated the probability (percentage amount) that Dunball (investor company) has the capacity to control Tonens (investee company).

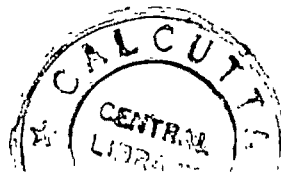
Research Instrument Subjects were sent via mail a research instrument which contained three components. They were a company description, an accounting scenario and a hypothetical accounting standard (RB Consolidated Accounts). The company description and accounting scenario were the same as the one used in Experiment 1, with the exception that half the subjects were told that Tonens returned a profit of \$7.3 million rather than a loss of \$7.3 million.

All subjects were asked to base their judgments on a hypothetical accounting standard—RB Consolidated Accounts, described above.

A comparison of the key differences between AASB 1024 and RB Std 51 / [RB Std 70] is contained in Table 4. Evident from Table 4, RB Std 51 is more precise in its guidance than AASB 1024. AASB 1024 is contingent upon the preparer of the accounts exercising 'professional skill and judgment' and considering 'substance rather than form'. In addition, it provides a list of factors which are categorized as 'indicators' of control.⁵ Conversely, while RB Std 51 does not provide *absolute rules*, it asks subjects to hinge their judgments to a specific benchmark, namely a probability threshold (51 per cent or 70 per cent). Further, it provides a list of factors which are categorized as 'evidence' of control. The 'indicators' of control

⁵ AASB 1024 para. (xvi) states any of the following factors would normally indicate the existence of control (by one entity of another entity):

- (a) the capacity to dominate the composition of the board of directors . . . ;
- (b) the capacity to appoint or remove all or a majority of directors . . . ;
- (c) the capacity to control the casting of a majority of the votes cast at a meeting of the board of directors . . . ;
- (d) the capacity to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of another entity . . . ; and
- (e) the existence of a statute, agreement, or trust deed, or any other scheme, arrangement or device, which in substance gives the entity the capacity to enjoy a majority of the benefits and to be exposed to the majority of the risks of that entity, notwithstanding that control may appear to be vested in another party.



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TABLE 4

COMPARISON OF KEY DIFFERENCE AASB 1024 AND RB STD 51 / [RB STD 70]

AASB 1024 <i>Determining Existence of Control</i> Whether an entity has control of another entity will always be a question to be decided in the light of the prevailing circumstances. The definition of control depends upon <i>substance rather than form</i> and, accordingly, determining the existence of control will involve the preparer of the financial reports in <i>exercising professional skill and judgement</i>. Any one of the following factors <i>would normally indicate</i> the existence of control by one entity of another entity.	RB Std 51 [RB Std 70] <i>Determining Existence of Control</i> If the preparer of the accounts believes that there is at least a <i>51% probability</i> [in RB Std 70–70%] of one entity having the capacity to control another entity, then consolidated accounts must be prepared. Any of the following factors <i>is evidence</i> of the existence of control by one entity of another entity.
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listed in AASB 1024 are identical to the factors considered ‘evidence’ of control in RB Std 51.

Subjects in Experiment 2 from the Loss group were provided with the same background information and incentives (i.e., not to consolidate) as were Experiment 1 subjects. In addition, half of the Loss group subjects received an accounting standard (RB Std 51) which specifies that, ‘if the preparer of the accounts believes that there is *at least a 51 probability* of one entity having the capacity to control another entity, then consolidated accounts must be prepared’. Recall that 51 per cent was selected because it was the median AASB 1024 score in Experiment 1. On this basis, it is argued that subjects regarded AASB 1024 equally as stringent as RB Std 51. Accordingly, a direct comparison can be made of the judgments emanating from the Loss group who received RB Std 51 (Experiment 2), and the Experiment 1 subjects. Therefore, any difference between the consolidation recommendation of the two groups should be due to differences in the way accountants respond to a rules-based standard (Experiment 2 Loss group—RB Std 51) compared to their response to substance-over-form standard (Experiment 1). This method of comparison used to test H5 is based on Cuccia *et al.* (1995).

Results

As a manipulation check of the validity of the incentives variable, a debriefing question was included to determine subjects’ perceptions of the financial impact of preparing consolidated accounts. Subjects were asked to indicate their answer to the following question on a nine-point Likert scale (1 = *very much worsened*, to 9 = *very much improved*): Do you believe that Dunball Electrical’s financial position is worsened or improved by including Tonens Finance in its consolidated accounts? As expected, *Profit* subjects perceived Dunball’s financial position to be significantly better than *Loss* subjects. A one-way ANOVA indicated that the *Profit* subjects’ assessment of Dunball’s financial position ($M = 5.68$) was significantly greater than the *Loss* subjects’ assessment ($M = 3.68$) ($p = 0.001$). This

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TABLE 5
REPORTING RECOMMENDATIONS—EXPERIMENT 2

Subjects	Total	Recommend consolidation	Not recommend consolidation	$\chi^2 p =$
Panel A: Incentives				
All	121	60 (49.6%)	61 (50.4%)	0.008
Profit group	62	38 (61.3%)	24 (38.7%)	
Loss group	59	22 (37.3%)	37 (62.7%)	
Panel B: Incentive and stringency				
Profit group—RB Std 51	31	20 (64.5%)	11 (35.5%)	0.602
Profit group—RB Std 70	<u>31</u>	<u>18</u> (58.1%)	<u>13</u> (41.9%)	
	<u>62</u>	<u>38</u>	<u>24</u>	
Loss group—RB Std 51	28	10 (35.7%)	18 (64.3%)	0.812
Loss group—RB Std 70	<u>31</u>	<u>12</u> (38.7%)	<u>19</u> (61.3%)	
	<u>59</u>	<u>22</u>	<u>37</u>	

finding suggests that the manipulation of the financial performance of the investee company as an incentive was successful.

The reporting recommendations of Experiment 2 subjects is shown in Table 5, Panel A. The incentives variable (financial performance of the investee company) caused a significant impact on the subjects' consolidation recommendations. As hypothesized, a greater proportion of accountants who received the *Profit* incentive (and therefore the incentive to consolidate) recommended consolidation (61.3 per cent) than those who received the *Loss* incentive (37.3 per cent) ($\chi^2 = 6.97$, $p = 0.008$). Accordingly, H2 is supported.

To test H3, subjects' responses were analysed on the basis of the stringency of the standard and the incentives they received. Table 5, Panel B, provides a summary of the reporting recommendations for the four treatments and indicates that the reporting recommendation was not influenced significantly by the percentage threshold used. Chi-square testing did not indicate any significant difference between the consolidation recommendations of the Profit RB Std 51 subjects and the Profit RB Std 70 subjects ($\chi^2 = 0.27$, $p = 0.602$). Nor did it show any significant difference between the consolidation recommendations of the Loss RB Std 51 subjects and the Loss RB Std 70 subjects ($\chi^2 = 0.06$, $p = 0.812$). Therefore, hypothesis H3 is not supported.

Based upon the specific information provided in the case, subjects estimated the probability (i.e., case score) that the investor company has the 'capacity to control' the investee company. Subjects in the *Profit* treatments (incentive to consolidate) assigned higher case scores ($M = 64.47$) than subjects in the *Loss* treatments (incentive not to consolidate) ($M = 56.31$) ($t = 2.93$, $p = 0.003$). Therefore, incentives

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TABLE 6

RULES-BASED VS SUBSTANCE-OVER-FORM REPORTING RECOMMENDATIONS

Subjects	Total	Recommend consolidation	Not recommend consolidation	χ^2 $p =$
Experiment 1—subjects (substance-over-form)	58	33 (56.9%)	25 (43.1%)	0.066
Experiment 2—Loss group (rules-based) RB Std 51	28	10 (35.7%)	18 (64.3%)	
Total	86	43	43	

to consolidate affected subjects' assessments of the case specific information, supporting H4.

To test H5, judgments made under rules-based standards were compared with those made under substance-over-form standards by comparing the consolidation recommendations of Experiment 1 subjects with Experiment 2—Loss RB Std 51 subjects. The former based their judgments on a substance-over-form standard, whereas the latter subjects based their judgments on a more rules-based standard. The results of the comparison are presented in Table 6. The chi-square analysis indicated that Experiment 1 subjects were more likely to recommend consolidation than Experiment 2—Loss RB Std 51 subjects. These results are marginally significant ($\chi^2 = 3.40$, $p = 0.066$) and therefore the null hypothesis H5 is rejected. As both groups had the same incentive not to consolidate, the results in Table 6 indicate that subjects' consolidation recommendations appeared to be influenced more by incentives under a rules-based standard (RB Std 51) than under a substance-over-form standard (AASB 1024).

DISCUSSION

Experiment 1 examined consolidation judgments by experienced accountants using a substance-over-form accounting standard. It specially addressed the relationship between consolidate/not consolidate judgments and the interpretation of accounting standard stringency and assessment of case specific information. Subjects were found not to make different interpretations of the phrase 'capacity to control' in AASB 1024 depending on the consolidation judgment they made. However, those who made more aggressive reporting recommendations were more likely to assess case specific information aggressively than those who did not make aggressive reporting decisions. These results suggest that subjects justified their non-consolidation recommendations through their assessment of case specific information. These results support the findings of Cuccia *et al.* (1995) in a tax setting. These results also raise a problem for accounting standard setters. While they can vary the guidance in standards, preparers appear to vary their assessments of case specific information to fit with their judgments.

Experiment 2 examined consolidated judgments using a rules-based accounting standard. When using a rules-based standard, incentives were found to affect accountants' consolidation judgments. As hypothesized, a significantly greater proportion of subjects in the profitable investee treatment recommended consolidation than those in the loss investee treatment. These results are consistent with the emerging literature described by Libby *et al.* (2002) which suggests that auditors and managers use the flexibility in accounting rules to make disclosure favouring their incentives. Overall, while the results showing that participants on average make judgments consistent with their incentives is not surprising, the study explicates how those incentives are used. Accountants who make more aggressive reporting decisions could do this through accounting standards or the interpretation of case specific information. We found it was the latter for both types of standards.

This work is being published in a post-Enron environment where there has been a growing concern that the standard setting process in some environments including the U.S. may have become overly rules-based (SEC, 2003). It follows also Libby *et al.* (2002) who suggest the need for research that addresses how changes in regulations might affect the aggressiveness of financial reporting. Comparison of the judgments made in Experiment 1 with one of the treatment groups in Experiment 2 (Loss RB Std 51) allowed us to address this question by comparing the consolidation recommendations of subjects using a rules-based accounting standard compared with those using a substance-over-form accounting standard. While both groups had the same incentives not to consolidate, marginally, significantly more subjects using the rules-based standard did not consolidate than subjects using the substance-over-form standard. This is contrary to anecdotal claims that the imprecision of substance-over-form standards may be less effective in stopping biased financial reporting than rules-based standards.

The reported results do not support a move away from substance-over-form to more rule-based standards and supports the view that modifications to accounting standards making them rule-based will only be effective when practitioners do not compensate for losing a vague standards latitude by assessing more liberally the evidential support for their preferred position (Cuccia *et al.*, 1995). Given that subjects in the rules-based treatments assessed case specific information more aggressively when they had incentives to consolidate it appears that the use of rules-based standards will not necessarily reduce aggressive reporting. Also, increasing the stringency of the standard in this study did not affect consolidation judgments. Providing more stringent standards may simply encourage innovations which are designed to achieve the same outcomes that are consistent with the accountants' incentives but through different means such as their interpretation of case specific information.

In interpreting the results a number of limitations should be noted as well as the related future research opportunities. First, we chose one type of rules-based standard. There are many other types of such standards and they vary in the degree of precision. Future research should consider such alternatives and their impact on preparer judgments. Second, we varied our probability threshold across two levels, 51 per cent and 70 per cent. As both of them are above 50 per cent, future research

that considers the stringency of standards could use a larger range of probability thresholds. Third, to test H5 we compared data from Experiment 1 with data from Experiment 2. This raises validity threats, particularly as the data were collected three months apart. Mitigating this threat is the fact that subjects came from the same subject pool, there are no statistical differences in their attributes and we found no environmental events between the collection of the two sets of data that would be expected to affect judgments. Future research could consider the use of a fully crossed design using a standard of different stringency and different levels of incentives.

Overall, this article has broadened the scope of judgments studied in the accounting literature. Previous research has generally ignored the judgments of preparers. Understanding of those judgments is important to standard setters and there is a need to study a much wider range of preparer judgments. Also needed is an investigation of a broader range of questions of how accounting information can be improved. One such example is investigating in controlled laboratory settings the calls over many decades for accounting to 'tell it how it is' (e.g., Chambers, 1973; Clarke and Dean, 1992, 2002). The design of such experiments will not be easy but the incremental contribution to knowledge and the impact on the profession could be substantial as it has the potential to assist in restoring the public's faith in the profession.

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C. JANIE CHANG AND JOANNA L. Y. HO

Judgment and Decision Making in Project Continuation: A Study of Students as Surrogates for Experienced Managers

This work explores the efficacy of using students as surrogates for experienced managers in escalation studies. Participants were 222 managers with substantial project planning and evaluation experience and 146 undergraduate business students. Our results show that the experienced managers exhibited a strong tendency to continue projects, with this tendency being positively related to the degree of project completion. The managers also tended to invest a greater amount of additional resources in response to favourable rather than to unfavourable information, contingent on the degree of project completion. In contrast, the students' decisions showed little sensitivity to the contextual information, and they exhibited no association between the likelihood they would continue a project and how much funding they would allocate to the project. These results suggest that caution is needed in generalizing student-based escalation findings to real-world business settings.

Key words: Decision making; Management accounting; Project evaluation; Surrogacy.

In the literatures of business and academia, it is lamented that managers experiencing unexpected setbacks often escalate resources to losing courses of action. Many studies have sought to determine the factors that evoke this escalation phenomenon. Finance-agency literature, for example, suggests that complex intrafirm relationships in large organizations may cause managers to be reluctant to acknowledge failure by discontinuing projects (Boot, 1992; Lang *et al.*, 1995; Weisbach, 1995).¹ An examination of the extant research on escalation reveals evidence that tends to be anecdotal or limited in scope, and only a few studies have drawn

¹ Reviews of this literature have been provided by Conlon and Leatherwood (1989), Brockner (1992), Wilson and Zhang (1997) and Chang *et al.* (2002) among others.

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support from real-world cases or use practitioners as subjects (e.g., Kull, 1986; Chenhall and Morris, 1991; Keil, 1995; Garland and Conlon, 1998). By far the majority of escalation studies have used students as surrogates for managers (e.g., Conlon and Garland, 1993; Harrison and Harrell, 1993; Ghosh, 1997). Determining whether the escalation phenomenon is as extensive as claimed and due to the suggested causes (thus, whether the suggested remedies would be effective) depends critically on whether students are appropriate surrogates for experienced managers in project continuation decisions.

The findings to date have been mixed as to whether students are adequate surrogates for business decision makers. A review of this research in the next section suggests that the adequacy of student surrogates depends on the type of decision being investigated, because different decisions may require various types of experience and expertise. The review also shows a dearth of surrogacy studies focused specifically on escalation and indicates the need for such investigations.

This article advances understanding of the surrogacy issue in an escalation context. At a more general level, it also adds to the body of findings relating to students as surrogates for real-world decision makers. Managers with an average of fifteen (eight) years work (including project planning/evaluation) experience were compared with undergraduate business students. Participants were asked how likely they would be to continue a project before and after receiving different types of market information, given that the project had either a high or a low degree of completion. Participants also were asked to decide the amount of additional funding they would allocate to the project. The results indicate that experienced managers had a strong tendency to continue the project. This appears to have been influenced jointly by the degree of project completion and the nature of the market information. Also, managers' funds allocation decisions were found to be correlated positively with their likelihood judgments. In contrast, the students showed no sensitivity to the contextual information and no association with their likelihood judgments. Those results further indicate differences between the managers' and the students' uses of information. Even when the managers and students reported using the same items of information, their judgments and decisions often differed. Taken as a whole, the findings raise doubts about the appropriateness of students as surrogates for experienced managers in escalation contexts, which leads to questions about the real-world generalizability of student-based escalation findings.

LITERATURE REVIEW

The Empirical Basis of Extant Escalation Findings

Table 1 summarizes key aspects of representative escalation studies in both generic and business investment contexts. The vastness of the escalation literature makes it infeasible to construct an all-inclusive table. Nevertheless, the coverage in Table 1 is very extensive and, to our knowledge, inclusive of the often-cited studies on which common conclusions on the escalation phenomenon are based.

Table 1 shows that a few prior studies are based on real-world observations. Kull (1986), for example, reports on the design and implementation of a complex

TABLE 1
A SUMMARY OF REPRESENTATIVE ESCALATION STUDIES

Author(s) and years	Subjects	Focus	Major findings
Panel A: Generic and personal contexts			
Rubin and Brockner (1975)	Undergraduate students (UGS)	Puzzle-solving contexts	More escalation when potential payoff was declining slowly than when it was fast declining.
Rubin (1978)	UGS	Generic game contexts	Students de-escalated earlier and were more aware of cost when presented with a cost schedule. More escalation when the initial resources were provided by others rather than viewed as one's own.
Caldwell and O'Reilly (1982)	UGS	Employee hiring decision	Subjects who were held accountable for the losses included in their report more favourable information items than those who were not accountable for the losses.
Brockner <i>et al.</i> (1986)	UGS	Generic game contexts	Subjects under diagnostic feedback escalated more than those under non-diagnostic condition.
Schoorman (1988)	Clerical employees	Employee hiring and promotion decisions	Subjects who participated in a hiring or promotion decision and agreed (disagreed) with the eventual decision would positively (negatively) bias subsequent performance appraisal ratings for that employee.
Heath (1995)	UGS	Effect of how cost is measured on cost awareness	Additional investment that was not of the same measure as the original investment, e.g., additional work vs initial investment in money, was likely to be treated as incidental and less costly.
Odean (1998)	Individual investors	Buying and selling of investments	Investors tend to hold losing investments too long and sell winning investments too soon.

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Panel B: Business Investment contexts

Staw (1976) Staw and Fox (1977)	UGS	Allocation of R&D funds	Subjects invested a larger amount of resources in a failing project when they had <i>initiated</i> the project than when they had <i>inherited</i> it.
Staw and Ross (1978)	UGS	Bank loan decisions	Subjects processed information differently after a failure as opposed to a success experience.
Fox and Staw (1979)	UGS	Job insecurity and resistance from others	More escalation when subjects felt insecure about their jobs and when receiving strong resistance from the board of directors.
Staw and Ross (1980)	UGS vs MBA students	Experience effect in investment strategies	MBA students preferred the persistent strategy to the switching one, while undergraduate students from both psychology and business rated the two strategies equally.
Brockner and Rubin (1985)	UGS	Investment mode	Passive investment mode gave rise to more escalation than active investment mode.
Davis (1985)	n.a.	Cost overruns and project escalation	Suggested steps to control cost overruns and to avoid escalation are: (a) verifying the nature of the problem; (b) identifying underestimated areas; (c) avoiding false solutions; (d) recosting the entire project; and (e) abandoning the project if necessary.
Kull (1986)	n.a.	A real world escalation example	The project team misused a fourth-generation programming language and its escalation behaviour caused a total failure of the New Jersey DMV's implementation of a new information system.
Conlon and Parks (1987)	MBA students	Feedback and responsibility	Subjects chose more past-oriented information items in the high responsibility and negative feedback condition than in all other conditions.
Garland <i>et al.</i> (1990)	UGS vs geologists	Experience effect in an oil exploration context	When encountering negative feedback (dry wells), geologists tended to discontinue investment; however, students escalated their investment.
Chenhall and Morris (1991)	Managers	Cognitive style and responsibility	Sensation-oriented managers tended to include sunk cost in decision making and intuition-oriented managers often tended to exclude opportunity cost in decision making. However, they all ignored sunk and opportunity costs when they felt individually responsible for the project.

TABLE 1
(CONTINUED)

Author(s) and years	Subjects	Focus	Major findings
Simonson and Staw (1992)	UGS	Performance evaluation methods	Fewer resources were allocated to a failing project when subjects were held accountable for the decision process rather than the decision outcomes.
Harrison and Harrell (1993)	MBA students	Information asymmetry and reputation	More escalation when possessing private information about investment outcomes, and when quitting the current project could damage their future employment opportunities.
Conlon and Garland (1993)	UGS	Project completion and information about competitors	More escalation when it was close to completion and when competitor was not threatening. Also, subjects were influenced more by degree of completion than by sunk cost.
Mannix and Lowenstein (1993)	MBA students	Job mobility and prior knowledge	Either high job mobility rate or prior knowledge of job mobility can cause a higher percentage of cash withdrawal.
Rutledge and Harrell (1993)	Managers	Responsibility and framing of accounting information	More escalation when subjects had initiated the project and when the project is framed as a failing project.
Keil (1995)	Employees in a computer company	Identifying factors that promote escalation	The results of the field study suggest that escalation can be attributed to factors related to specific projects, social norm, organizational environment and decision makers' own characteristics.
Ghosh (1997)	Accounting UGS and MBA students	De-escalation of commitment by control procedures	Escalation of commitment was significantly reduced when precise feedback, progress report and information on future benefits of additional expenditures were provided.
Garland and Conlon (1998)	Bank managers MBA students Chinese graduate students	Project completion	Subjects' willingness to continue investing in an R&D project is more influenced by information about the degree of project completion and not by information about sunk costs.

computer-based system for the New Jersey Division of Motor Vehicles. At an early stage, there were clear indications that the proposed system could not perform the required tasks. Nevertheless, the managers continued the project to its completion, at considerable cost and embarrassment to the large CPA firm responsible for the project. Keil (1995) reports on a similar experience at a computer company. Two key managers became aware of an expert system's superior performance in manufacturing functions and decided to invest in a similar system for the sales department. Despite receiving consistently unfavourable feedback and being aware of the very low applicability of the resulting system, the managers continued to fund the project for more than ten years before finally terminating it. In another study, using the data of 10,000 investment accounts across six years, Odean (1998) found that investors tended to hold losing investments too long and to sell winning investments too soon. These real-world examples notwithstanding, the overwhelming majority of the studies have been laboratory experiments, mostly with student subjects. These experiments relate to a wide variety of tasks. For example, in a business-related context, Staw (1976) and Staw and Fox (1977) asked undergraduate students to allocate R&D funding between two company divisions. They found that the students allocated more resources to a failing course of action when they had initiated it than when it had been initiated by others. Harrison and Harrell (1993) found that MBA students tended to escalate more when they possessed private information about the project's unfavourable future prospects and when abandoning the project could damage their employment prospects.

Table 1 also presents data where practicing managers were the subjects. Chenhall and Morris (1991), for instance, studied the effects of managers' cognitive styles and responsibility on their decisions. They reported some effects of cognitive style on managers' consideration of sunk costs (e.g., escalation), but the overriding factor was managers feeling individually responsible for the project's initiation. Garland and Conlon (1998) asked graduate students and mid- and senior-level bank managers to make funding decisions in contexts involving sunk costs and different degrees of project completion. Age, years of banking experience and years of lending experience were found to have no impact on the bank managers' likelihood judgments regarding further funding of the project. Degree of project completion had a strong effect, but amount of sunk cost had no effect at all. Thus, the studies by Chenhall and Morris (1991) and Garland and Conlon (1998) have provided insights into managers' escalation behaviour, but neither investigated the surrogacy issue. Chenhall and Morris did not include student subjects, and the students and managers in the study of Garland and Conlon were given different cases, rendering non-comparable results.

Findings on Students' Adequacy as Surrogates for Real-World Decision Makers

While concern has long been expressed about the use of surrogates in escalation studies (e.g., Conlon and Parks, 1987; Northcraft and Neale, 1986), this issue has, to date, received scant empirical investigation. In contrast, numerous studies of surrogacy have been conducted in other contexts, with mixed results. Some have found students to be adequate surrogates for real-world decision makers. For

example, simulation studies that examined marketing and advertising issues have revealed no difference between managers and students (Waters and Collins, 1984; Kuehn *et al.*, 1996). In an inventory management context, Mowen and Mowen (1986) found that both students and managers exhibited the same pattern of decision bias due to the way the information was framed. Bearing more directly on the escalation phenomenon, Harrison and Harrell (1993) found that differences in supervisory experience and years of business experience did not account for the differences in their subjects' responses.

However, other studies have cast doubt on the adequacy of student surrogates. Stafford (1998) and Yavas (1994) found students to be poor surrogates for real-world consumers, since typical students often did not use the products being tested. Robinson *et al.* (1991) suggested that students and entrepreneurs differ on a variety of characteristics that are dynamic across time and situations. They concluded that it is risky to perform entrepreneurial research using student subjects. In addition, studies of decision making which involve using financial information have generally found differences between students and experienced decision makers. For example, Bouwman (1984) found that financial analysts and students had significantly different reasoning processes. In auditing contexts, Frederick and Libby (1986) and Frederick (1991) demonstrated differences in the knowledge structures of experienced auditors and undergraduate accounting students. In the specific case of estimating conjunctive probabilities, Ho and Keller (1994) reported that experienced auditors' judgments were affected significantly by whether they had made predictions prior to diagnoses. Such an influence was not evident in undergraduate students with little or no auditing experience. Focusing on accounting issues, Houghton and Hronsky (1993) examined whether accounting students and professionals attribute the same meaning to accounting concepts. They found that both groups had similar cognitive structures, but that students positioned accounting concepts within their structure in a significantly different way from accounting practitioners. Houghton and Hronsky's conclusion that accounting students are not suitable surrogates for accounting professionals is similar to that of some earlier accounting researchers (Fleming, 1969; Copeland *et al.*, 1973).

In summary, these findings from different decision contexts (e.g., marketing, inventory management, accounting and auditing) suggest that the adequacy of student surrogates depends on the type of decision being investigated, perhaps because different decisions require different types of experience and expertise. This inference is consistent with prior findings that task-specific experience affects the structure and organization of knowledge learned and stored in memory (e.g., Shanteau, 1989; Bonner and Pennington, 1991; Libby, 1995).

In project continuation judgments and decisions, a central decision making principle is the irrelevance of sunk costs, which is stressed in all introductory management accounting textbooks. However, business students are unlikely to have had many opportunities to apply this principle to real business decisions. Dearman and Shields (2001) point out that in individuals who lack domain-related experience, cost-accounting knowledge content may not be organized and structured effectively. Thus, it is expected that student participants are influenced by (irrelevant) sunk

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costs. On the other hand, experienced managers are likely to be far more in tune with the concept and application of sunk costs in resource allocation through numerous direct (e.g., project management/completion) and indirect (e.g., review and monitoring others' work) task-related encounters.

Garland *et al.* (1990) reported this expected difference between students and real-world decision makers. In an oil exploration scenario, petroleum geologists and undergraduate students were given a budget to drill five producing (i.e., not dry) wells, and informed about the costs of initiating drilling and finishing construction of a producing well. They were asked to assess both the likelihood that the new well would produce and their own willingness to drill a new well, given that one to four dry wells have already been drilled. The geologists significantly lowered their likelihood judgments that the new wells would produce, as the number of dry wells already drilled increased from one to four. They also were less inclined to authorize drilling another new well if dry well(s) (negative feedback) had been encountered. In contrast, students' assessments were not sensitive to the number of dry wells already encountered. Thus, in their direct test of surrogation in an escalation context, Garland *et al.* found students to be inadequate surrogates for real-world decision makers. While this finding is informative, further tests are needed to assess its robustness.

Another important consideration is that the decision setting used by Garland *et al.* (1990) was primarily a technical one which did not require the extensive business/financial expertise often needed to make project continuation decisions. The importance of domain-specific experience in surrogacy tests is supported by audit judgment research, which has documented that differentiating experts and novices requires that the experimental task engages expert subjects' expertise (cf. Libby, 1995). This factor may have contributed to Harrison and Harrell's (1993) finding, noted earlier, that MBA students' years of supervisory and business experience had no effect on their escalation decisions. Harrison and Harrell suggested, as have other studies of escalation (e.g., Northcraft and Neale, 1986; Conlon and Parks, 1987), that the type of experience subjects have must be germane to the nature of the task.

The preceding literature review and discussion of escalation research make a case for investigation of the surrogacy issue. The hypothesis below provides some focus for such an investigation. Since it is evident from Table 1 that a wide range of variables and contexts could be studied, the proposition is stated in general terms to allow for a wide scope. In the Method section, we explain the specific variables and contexts that we have selected for this study.

H1: Experienced managers are more likely to make different judgments and decisions in escalation situations than students.

METHOD

Research Design

This study uses a 2 (levels of experience) $\times$ 2 (degrees of project completion) $\times$ 2 (natures of market information) factorial design, with the first two being

between-subject factors. Below, two additional factors (degree of project completion and nature of market information) are discussed.

Degree of Project Completion Previous works uniformly found this variable to affect students' commitment to a course of action (Garland, 1990; Garland and Newport, 1991; Conlon and Garland, 1993). For example, Garland and Newport (1991) reported that students were more willing to continue investing as the degree of project completion increased. To distinguish the specific effects of project completion from those of absolute amount of sunk cost, Conlon and Garland (1993) extended Garland and Newport's study by using four levels of sunk costs and degrees of project completion. In addition to confirming the project completion effect, Conlon and Garland found that the absolute amount of sunk costs had no impact on the student subjects' decisions. They explained the project completion effect with the notion of 'goal substitution'. That is, individuals subconsciously change their goals from profit maximization to task completion as time goes on, especially in a late stage of the project.

Furthermore, research on image theory suggests that people create and then rely on general and sometimes abstract images (goals) of events (e.g., project completion) to organize their thinking and direct their actions (Mitchell and Beach, 1990; Silver and Mitchell, 1990). While this explanation may apply in the case of students, other factors may counteract managers' tendency to continue projects with high degrees of completion. Experienced managers may be disciplined and use a variety of processes in making decisions. For example, managers realize that they need to observe ongoing projects and periodically evaluate them against targets such as return on investment. They understand that poorly performing projects should not be carried to completion. Hence, we expect students and managers to react differently to the degree of project completion, especially in light of new information (see below).

The Nature of Market Information Even if a project is implemented exactly as planned, it still may not achieve the targeted payoffs. Thus, ongoing projects should be re-evaluated periodically based on new information on the market and on competitors' actions. Early escalation studies have commonly found that students allocate more resources when new information is unfavourable than when it is favourable (e.g., Staw, 1976). Yet recent studies have yielded mixed results. As discussed earlier, Garland *et al.* (1990) found the decisions of experienced geologists were affected by unfavourable outcomes but students' decisions were not. Conlon and Garland (1993), on the other hand, found MBA students were less likely to invest additional funds to develop a new product if a competitor had a superior product.

The mixed results across student-based studies, *per se*, provide motivation for further study of this contextual variable. We expect experienced managers to invest more to capitalize on unexpected opportunities while stemming losses on projects expected to fall short of expectations. Replicating the findings of Garland *et al.* (1990) or Conlon and Garland (1993) would help us determine whether managers and students react differently to market information.

Participants

The participants were 229 managers and 146 undergraduate business administration students. Students completed the experiment in classroom settings in two major State universities in south-western U.S.A. They were enrolled in the final part of a managerial accounting course and, as is explained below, all had passed a knowledge test containing four questions on conceptual knowledge of relevant costs and sunk costs.

The manager participants were recruited based on an alumni list from the graduate school of business of a western State university in the U.S. The experimental packet included a case booklet and a cover letter from the business school dean encouraging participation. From the first mailing to 614 managers, 140 responses were received. Another 89 responses were obtained after a follow-up mailing. The overall return rate of 37.3 per cent compares favourably to the usual mail survey response rate of 20 per cent or less (Kanuk and Berenson, 1975; Biner and Kidd, 1994). There were 222 usable responses in total.² Since we found no significant difference in the responses from the two mailings, we combined them for data analyses. The managers' work experience ranged from three to forty-four years, with an overall mean and median of 15.27 and 14 years, respectively. Most participants were at the level of manager, director, controller, or a similar management position. More importantly, their experience in project planning/evaluation ranged from one to forty years, with a mean (median) of 8.03 (6.0) years. As is discussed below, we also examined the effects of the differences in the managers' years of experience.

Experimental Materials and Procedure

The experimental packet contained a cover letter with instructions, a guarantee of anonymity, and a capital budgeting case. This case was adapted from Chenhall and Morris (1991) and was pre-tested for clarity and understandability using six PhD students, seven MBA students and four management professionals. The case scenario contained a detailed narrative of a hypothetical company's sales revenues for the past year, growth rate as shown by the past ten years' sales revenues, the company's operating goals, and some marketing research information regarding a new product currently under development.

Subjects were asked to assume the role of a manager in charge of a new product's development and to proceed through the case scenario in three stages. In stage 1, they were informed that they already had spent \$375,000 on market research for the product. They needed to invest an additional \$90,000 to extend a new ventilation and heating system and another \$110,000 for high-speed packaging equipment. Half of the subjects were told the project was nearly finished (90 per cent), the other half was provided with a low degree (10 per cent) of completion. After reading the case, the subjects were asked how likely it was they would

² Five respondents indicated that they lacked project planning/evaluating experience, while another two lacked knowledge of relevant costs and sunk costs, as determined by scores of zero on the four test questions in the knowledge test.

choose to continue the project. The eleven-point scale ranged from 0 to 100, with 0 labelled 'will not continue' and 100 labelled 'will definitely continue'.

In stage 2, the market information was introduced. Subjects were told that they had either no competitor (i.e., favourable condition) or a strong competitor (i.e., unfavourable condition) for the product under development. In the latter case, the expected profitability from the product was reduced by 40 per cent from the original forecast. Since favourable/unfavourable market information was included as a within-subject factor, the order of presentation in each half of the sample was the reverse of the other half's. In conjunction with the two levels of project completion (a between-subjects factor), this reversed ordering yielded four distinct versions of the instrumental packet, and these were distributed randomly to the participants. Although the subjects were assigned at random and in equal numbers to each version, managers' and students' usable response rates were unequal across versions. The numbers of usable responses for the four conditions were 61, 56, 46, 59 for managers, and 55, 31, 31, 29 for students. After reviewing the new market information, subjects were again asked to indicate their likelihood of continuing the project.

In stage 3, subjects were informed that the original \$200,000 (i.e., \$90,000 + \$110,000) still was not enough and that an additional \$30,000 would be needed. Based on the last-presented favourable or unfavourable piece of market information, participants were asked to indicate how much they would allocate to the project from a \$150,000 operating budget. To control for the within-subject design, questions related to subjects' initial and revised likelihood judgments were presented on different pages, with instructions to complete the questions in the order given. Subjects were also told that they could refer back to the case scenario but were not to change answers to any previously completed questions. Inspection of the completed instruments did not reveal evidence that answers had been erased or otherwise changed.³

After making their project judgments and decisions, the subjects were asked to check items that they might have used in their decision making and also to respond to a knowledge test containing four questions from accounting textbooks and CPA exams. Results show that the mean (standard deviation) scores of correct answers for managers and students are 3.28 (0.85) and 3.14 (0.94), and that the means are not significantly different ($t = 1.48, p < 0.14$).

Finally, manager subjects were asked to provide demographic information, including their project evaluation experience. These responses indicate that 52 per cent of the managers had spent at least half of their work time planning and evaluating projects and the rest had spent some time doing this type of work. Both managers and students responded to an exit questionnaire on the case's degrees of interest, realism and difficulty (using a seven-point scale, with 1 = 'low' and 7 = 'high'). For the managers, the means (standard deviations) were 4.41 (1.17)

³ While this cannot rule out the possibility of subjects reading through the entire instrument before making any responses, our direct observations, in the case of the student participants, did not suggest that this practice had occurred.

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for 'interest', 4.20 (1.13) for 'realism', and 3.10 (1.19) for 'difficulty'. The students' responses for 'interest' and 'realism' were in a similar range, with means (standard deviations) of 4.62 (1.46) and 4.70 (1.09), respectively. However, the students attributed a somewhat higher level of difficulty to the case, with a mean (standard deviation) response of 4.04 (1.25).

RESULTS

Table 2 presents the frequencies and percentages of information used by managers and students. Overall, managers used slightly more information items than students (6.02 vs 5.49). Except for 'Occurred marketing research cost' (i.e., sunk cost) and 'New product growth', all information items were used by a higher percentage of managers than students.

There was not any observed presentation order effect for the two types of market information in the initial analyses of variance (ANOVAs); hence, responses from both presentation orders for analysis were combined.

Managers' Likelihood Judgments and Funds Allocation Decisions

Panel A of Table 3 presents descriptive statistics for the experienced managers' mean likelihood judgments and mean amounts of funds allocated, crossed by degree of project completion and nature of market information. It shows that once the experienced managers had started a project, they leaned strongly towards continuance in both low and high project completion conditions (79 per cent and 90 per cent, respectively). The ANOVA results from Table 4 show that this tendency to continue was affected by the degree of project completion ($F = 25.52$,

TABLE 2
FREQUENCIES OF SELECTED INFORMATION ITEMS BY MANAGERS
AND STUDENTS

Information type	Managers		Students	
	Frequency	%	Frequency	%
New product's growth rate	159	71.6	113	77.4
Total investment cost	150	67.6	93	63.7
IRR of the new product	148	66.7	85	58.2
Likelihood of having a competitor	140	63.1	88	60.3
NPV of the new product	135	60.8	84	57.5
Degree of project completion	126	56.8	67	45.9
Incremental cost	124	55.9	55	37.7
Current market discount rate	105	47.3	64	43.8
Sales growth rate	100	45.0	54	37.0
Occurred marketing research cost	84	37.8	61	41.8
Last year's sales revenue	65	29.3	37	25.3

TABLE 3

**DESCRIPTIVE STATISTICS FOR MANAGERS' AND STUDENTS' LIKELIHOOD
JUDGMENTS AND FUND ALLOCATION BY DEGREE OF PROJECT COMPLETION
AND TYPE OF MARKET INFORMATION**

	Panel A: Managers			Panel B: Students		
	Project completion			Project completion		
	10%	90%	Total	10%	90%	Total
Initial likelihood judgment	.79	.90	.84	.73	.81	.77
Revised likelihood judgment						
Favourable information	.88	.95	.91	.88	.93	.90
Unfavourable information	.58	.75	.66	.60	.61	.60
Total	.73	.85	.78	.74	.77	.75
Funds allocation						
Favourable information	\$21,177	\$19,271	\$20,199	\$21,346	\$24,997	\$23,171
Unfavourable information	\$17,848	\$13,610	\$16,027	\$22,167	\$22,963	\$22,453
Total	\$19,442	\$16,791	\$18,188	\$21,878	\$23,960	\$22,747

TABLE 4

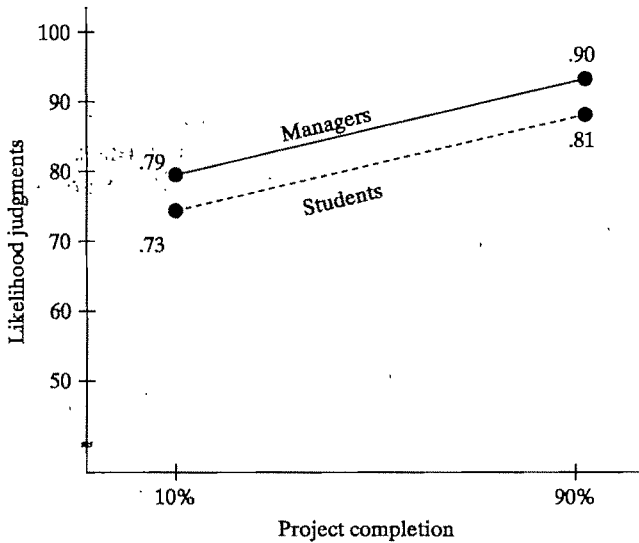
**ANOVA RESULTS FOR MANAGERS' LIKELIHOOD JUDGMENTS AND
FUND ALLOCATION**

Source	Mean square	df	F	p
Initial likelihood to continue the project				
Completion (C)	7074.49	1	25.52	.0001
Residual	277.20	220		
Revised likelihood to continue the project (repeated measures)				
Between-subject effect				
Completion (C)	14935.50	1	23.84	.0001
Residual	626.53	220		
Within-subject effect				
Information (I)	68652.33	1	245.30	.0001
C × I	2401.58	1	8.58	.004
Residual	279.87	220		
Funds allocation				
Completion (C)	520.00	1	4.09	.04
Information (I)	1100.00	1	8.75	.003
C × I	75.00	1	.59	.44
Residual	127.00	218		

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FIGURE 1

MANAGERS' AND STUDENTS' MEAN INITIAL LIKELIHOOD JUDGMENTS BY PROJECT COMPLETION



$p < 0.0001$). Plots of the mean values reported in Table 3 (for both manager and student subjects) are provided in Figures 1, 2 and 3.

Panel A of Table 3 and Panel A of Figure 3 show that across both types of market information, managers would allocate more funding to the project when its completion is low (\$19,442) than when it is high (\$16,791). The difference is statistically significant ($F = 4.09$, $p < 0.04$; Table 4). Thus, compared to the student-based findings of prior studies (e.g., Garland 1990; Garland and Newport 1991; Conlon *et al.*, 1993), the experienced managers in our experiment appear to be not as susceptible to the 'goal substitution' effect.

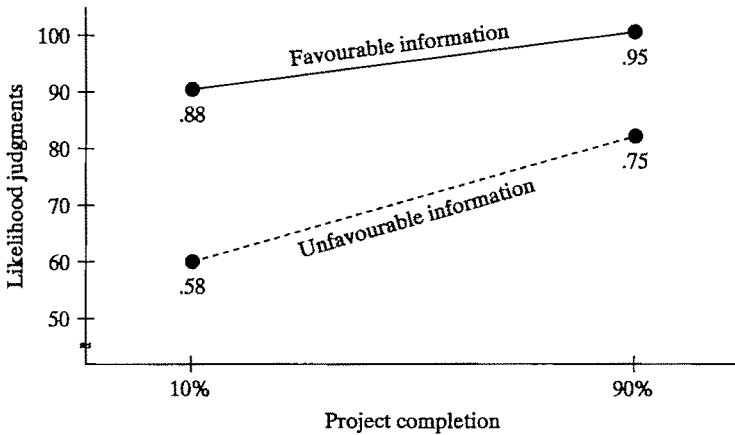
Focusing on the managers' responses to new information, Panel A of Table 3 and Panel A of Figure 2 show that the means of managers' revised likelihood judgments after receiving favourable versus unfavourable information are 91 per cent versus 66 per cent, with the difference being statistically significant ($F = 245.30$, $p < 0.0001$; Table 4). Consistent with our conjecture, the managers would allocate more funding after receiving favourable than unfavourable information (\$20,199 vs \$16,027; Table 3, Panel A and Figure 3, Panel A), with the difference being statistically significant ($F = 8.75$, $p < 0.003$; Table 4).

Table 4 further indicates an interaction effect between project completion and the nature of market information on managers' revised likelihood judgments ($F = 8.58$, $p < 0.004$). For the direction of this revision, see Panel A of Table 3 and Figure 2, Panel A. After receiving favourable market information, the managers' mean revised likelihood judgments are 88 (95) per cent when the project completion

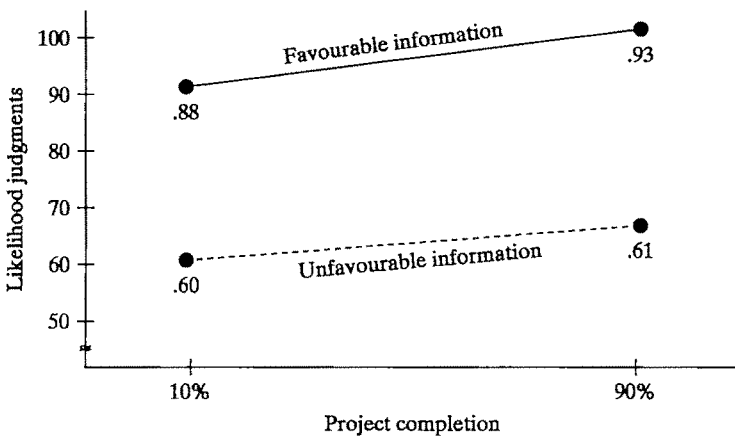
FIGURE 2

MANAGERS' AND STUDENTS' MEAN REVISED LIKELIHOOD JUDGMENTS
BY MARKET INFORMATION AND PROJECT COMPLETION

Panel A: Managers



Panel B: Students



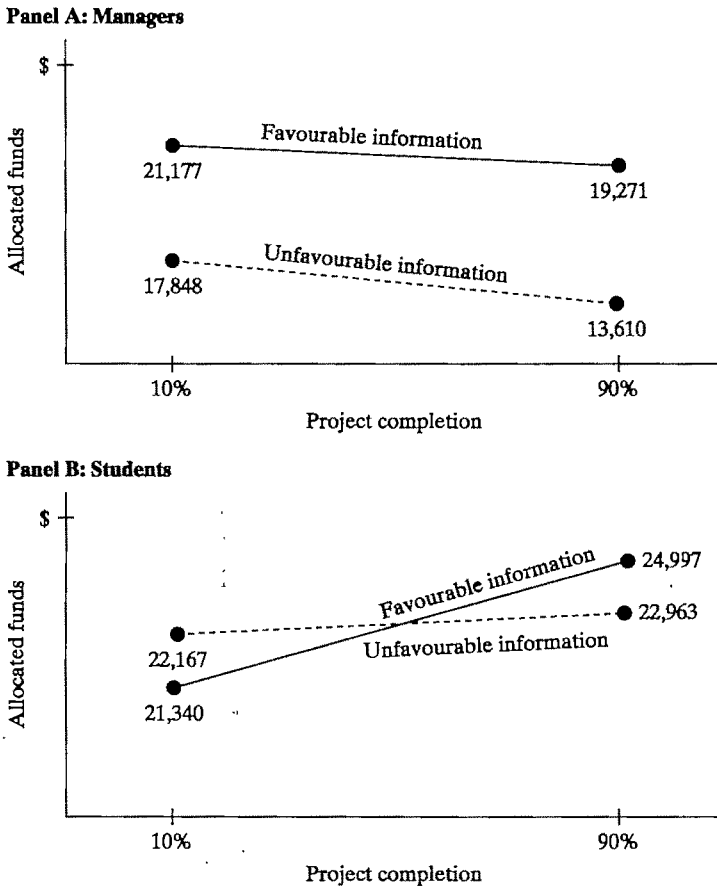
is low (high). On the other hand, the corresponding numbers are 58 (75) per cent when the market information is unfavourable. In addition, using paired t -tests, the effect of project completion on the change between managers' original and revised judgments was significant ($t = 2.88$, $p < 0.004$) when favourable information was received but insignificant ($t = 1.67$, $p < 0.10$) for unfavourable information. Thus, the managers' reaction to the degree of project completion is contingent on the nature of market information.

Since there was a wide range in the participating managers' project planning and evaluation experience, we further tested the sensitivity of their likelihood

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FIGURE 3

MANAGERS' AND STUDENTS' MEAN FUNDS ALLOCATION BY MARKET INFORMATION AND PROJECT COMPLETION



judgments and funds allocation decisions to this variable.⁴ Significant main or interact experience effects were not observed, indicating that all of the manager participants had been on the job long enough to be considered experienced in making decisions related to project continuation decisions. Furthermore, ANOVAs

⁴ Managers were classified into high versus low experience using alternate cutoffs (e.g., three years or above vs below three years; above four years vs four years or below). Each classification scheme was used to add the dichotomous experience independent variable to ANOVAs where the degree of project completion and nature of market information were the other independent variables. The dependent variables analysed in these ANOVAs were, respectively, the initial likelihood to continue the project, the revised likelihood to continue the project, and the funds allocation. Across eleven different ways of placing the managers into experience classes, there were few instances where experience had a significant main or interactive effect. The complete set of ANOVA results can be obtained from the first author on request.

were run with the dichotomous dependent variable (i.e., 'continue' or 'not continue'),⁵ resulting in qualitative results similar to that when likelihood judgment was used as the dependent variable.

Comparing Students' and Managers' Likelihood Judgments and Funds Allocation Decisions

The overall picture that emerges from comparing students and experienced managers is that they responded differently to the contextual factors. First, consider the likelihood judgments. A comparison of Panels A and B of Table 3 shows a higher initial mean likelihood judgment for the managers (84 per cent) than for the students (77 per cent). The overall ANOVA results in Table 5 indicate that the difference is significant ($F = 13.00$, $p < 0.0001$).

TABLE 5
ANOVA RESULTS FOR ALL SUBJECTS' LIKELIHOOD JUDGMENTS AND
FUND ALLOCATION

Source	Mean square	df	F	p
Initial likelihood to continue the project				
Completion (C)	8063.94	1	22.68	.0001
Experience (E)	4620.74	1	13.00	.0001
C × E	231.65	1	.65	.42
Residual	355.58	364		
Revised likelihood to continue the project (repeated measures)				
Between-subject effect				
Completion (C)	9036.97	1	14.48	.0001
Experience (E)	1971.60	1	3.16	.08
C × E	3256.57	1	5.22	.02
Residual	623.94	363		
Within-subject effect				
Information (I)	127942.80	1	484.04	.0001
I × C	387.59	1	1.47	.23
I × E	994.20	1	3.76	.05
I × C × E	1706.98	1	6.46	.01
Residual	264.32	363		
Funds allocation				
Completion (C)	14.00	1	.12	.73
Experience (E)	1800.00	1	16.46	.0001
Information (I)	500.00	1	4.48	.04
C × E	540.00	1	4.82	.03
I × C	130.00	1	1.16	.28
I × E	290.00	1	2.60	.11
I × C × E	1.31	1	.01	.91
Residual	110.00	341		

⁵ The midpoint of the response scale (i.e., 50 per cent) was used to categorize subjects' likelihood judgments into a decision either to continue or not to continue.

Table 5 also shows that the subjects' revised likelihood judgments (after receipt of market information) were influenced not only by their experience level ($F = 3.76, p < 0.05$) but also by the interaction of experience, degree of project completion, and nature of market information ($F = 6.46, p < 0.01$). More specifically, Table 3 and Panels A and B of Figure 2 show that when the market information was favourable, managers and students were equally likely to continue the project both when project completion was low (88 per cent vs 88 per cent) and high (95 per cent vs 93 per cent). The results of the planned comparison tests show that the differences are not statistically significant ($t = 0.06, p < 0.48$, one-tailed, for low project completion; $t = 0.48, p < 0.32$, one-tailed, for high project completion). However, when the market information was unfavourable and project completion was high, managers were more willing to continue the project than were students (75 per cent vs 61 per cent), with the difference being statistically significant ($t = 3.28, p < 0.001$, one-tailed). In contrast, when the market condition was unfavourable and project completion was low, managers and students displayed similar (weak) tendencies to continue the project (58 per cent vs 60 per cent; $t = 0.51, p < 0.31$, one-tailed).

Regarding funds allocation decisions, Table 5 and Panels A and B of Figure 3 show a strong experience effect ($F = 16.46, p < 0.0001$) and a strong interaction effect of project completion and experience ($F = 4.82, p < 0.03$). Recall that managers tend to allocate more funds in a low completion condition than in a high completion condition (\$19,442 vs \$16,791). Panel B of Table 3 reveals the opposite pattern among the students. As in Garland and Newport (1991) and Conlon and Garland (1993), the student subjects in the current study were allocated lower amounts of funds in the low completion than in the high completion condition (\$21,878 vs \$23,960), though the difference is not significant ($F = 1.71, p < 0.19$; Table 5). In contrast to managers' allocating more funds in response to favourable than to unfavourable market information (\$20,199 vs \$16,027), students were insensitive to the market information (\$23,171 in the favourable condition vs \$22,453 in the unfavourable condition; $F = 0.13, p < 0.72$; Tables 3 and 5, and Figure 3).

Also scrutinized was the relationship between likelihood judgments and funds allocation decisions. Pearson correlations reveal that managers' funds allocations were positively correlated with their revised likelihood judgments ($r = 0.24, p < 0.011$ in the favourable information condition; $r = 0.50, p < 0.0001$ in the unfavourable information condition). Thus, the more likely a manager was to continue a project, the more funds that tended to be allocated to it. However, with student subjects such a relationship was not evident ($r = 0.06, p < 0.67$ in the favourable information condition; $r = 0.19, p < 0.11$ in the unfavourable information condition).

Effects of Information Use by Managers and Students

To assess whether information use had the same effects on managers and students, regression analyses were undertaken with the participants' initial likelihood judgments as the dependent variable, and their use of the eleven information items, their experience level, and the project's completion percentage (90 per cent vs 10 per cent) as independent variables. Results show that managers' initial likelihood

judgments were influenced only by the manipulated project completion ($t = 4.866$, $p < 0.0001$) and not by any of the eleven information items listed. In contrast, students' initial judgments were significantly affected by the information items they used, such as 'New product's growth rate' ($t = 2.19$, $p < 0.03$), 'Occurred marketing research cost' ($t = -3.142$, $p < 0.002$), 'Current market discount rate' ($t = -1.981$, $p < 0.05$), 'Degree of project completion' ($t = 2.565$, $p < 0.01$), and 'Likelihood of having a competitor' ($t = -2.803$, $p < 0.01$).

Focusing on the participants' revised likelihoods (a within-subjects variable), general linear models were used with two revised likelihoods as the dependent variable and the manipulated project completion, information type, and the participants' use of each information item as independent variables. The results show that revised likelihoods were significantly affected by differences in managers' and students' use of 'Last year's sales revenue' ($F = 6.844$, $p < 0.009$) and 'Occurred marketing research cost' ($F = 6.313$, $p < 0.012$). Regarding the funds allocation decision, regression results suggest that managers were influenced by their use of 'New product's growth rate' ($t = 2.021$, $p < 0.05$) and 'IRR of the new product' ($t = 1.805$, $p < 0.07$). However, students' fund allocation decisions were not influenced by their use of any of the eleven items provided.

DISCUSSION AND CONCLUSION

Results suggest that managers with substantial project planning and evaluation experience have a strong tendency to continue projects. This tendency is stronger when the degree of project completion is high. Managers also are more willing to invest greater amounts of additional resources in response to favourable than to unfavourable information, with this willingness being contingent on the degree of project completion. Comparing students to managers reveals significantly different likelihood judgments and funds allocation decisions. An examination of participants' use of information items further suggests that differences in the information items chosen by managers and students probably account for the differences in their judgments and decisions. Hence, data here cast doubt on the efficacy of using students as surrogates for experienced managers in escalation studies.

In conjunction with shedding light on the surrogacy issue, the literature is advanced in two aspects. First, most studies have *separately* examined how the degree of project completion and the nature of market information affect individuals' likelihood judgments. Here it is suggested that these two factors act separately, as well as jointly, to affect individuals' willingness to continue a project. This interaction effect was evident with experienced managers as subjects but was absent for students. In the only prior study to have included both project completion and nature of information, Conlon and Garland's (1993) student subjects also failed to exhibit an interaction effect between project completion and negative/positive information on their likelihood judgments. Their result provides further support for our finding of a difference between managers' and students' project-related judgments.

The second contribution of this study lies in its examination of the relationship between subjects' likelihood judgments and funds allocation decisions. The vast

majority of earlier works have focused on the likelihood judgment by presenting a choice between two distinct options: abandonment, or continuing the project with a given amount of additional investment. Although research has examined the quality of individuals' judgments and decisions (Biggs *et al.*, 1988; Libby and Luft, 1993; Libby, 1995), there is a lack of any direct evidence of the linkage between them, with the existence of such a link being assumed rather than verified. In an escalation context, Ghosh (1997) did ask subjects to make both likelihood judgments and fund allocation decisions, but he used the subjects' responses only as dependent variables without examining their relations. Results here indicate that the managers' likelihood judgments are positively correlated with their funds allocation decisions, but this association is absent for the student subjects. Furthermore, the conditions under which students would be proper or improper surrogates for managers in allocating resources is identified. Students behave differently from managers when they make fund allocation decisions and when they make likelihood judgments in the presence of setbacks. On the other hand, with favourable market information, students make likelihood judgments similar to managers'.

Considering the surrogacy aspect of this study, it is important to note that we have tested only a small subset of the factors examined in the extant student-based escalation research. Tests of surrogacy can be extended to the other variables mentioned in the literature (see Chang *et al.*, 2002, for a review). Focusing specifically on experienced managers' escalation decisions, a similarly wide range of possibilities exists for future research. Four directions are particularly worthy of consideration.

First, managers' decisions about project continuation and funding are likely to depend on a variety of factors. These include personal attributes, such as professional training and job-specific experience; characteristics of the decision context, such as the organization's structure, policies and processes; and broader factors, such as labour market mobility and social norms. For example, firms often have controls and incentive schemes aimed at reducing information asymmetry and inducing managerial actions that further the organization's goals. To date, only Simonson and Staw (1992) have investigated the effects of performance evaluation methods on project continuation decisions. Much room exists for future research on how different types of performance evaluation/rewards (e.g., outcome- or process-based) independently, and jointly with the other factors, influence managers' project-related resource allocations.

Second, this study has examined only the differences in the judgments and decisions made by students and managers, without an evaluation of whether these were 'optimal' or 'rational'. Improving the effectiveness of resource allocations is the reason for being concerned with escalation. Hence, future studies could include some assessment of the extent to which these different decisions affect whether an organization reaches its objectives. Also, the current research design, which focuses on general likelihood judgments and fund allocation decisions and the items used by managers and students, was not detailed enough for us to distinguish possible explanations for managers' escalation behaviours. For example, are managers' escalation behaviours attributable to their irrationality (e.g., ignoring

increment cost or getting their money's worth) or to a conflict of interests? Future studies may examine the underlying reasons why managers tend to escalate resources in different allocation contexts.

Third, business organizations increasingly delegate decision-making authority to teams rather than to individuals. Yet only a few studies have explored the impact of group-versus-individual decision making on project continuation decisions (Rutledge and Harrell, 1994; Whyte, 1991, 1993), and they have produced mixed results. Examining the topic could mitigate this uncertainty. Finally, future studies could use more realistic case scenarios to examine the generalizability of this study's results. For example, the subjects in this study were given only limited information for their judgments and decisions. In messy decision settings, decision makers have access to richer information environments, which in turn could affect their project continuation decisions. In addition, students in the current study completed the experiment in class, while data from managers could be collected only through mailed surveys. Future studies could improve data compatibility by using more similar experimental settings.

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GERRY GALLERY AND NATALIE GALLERY

Applying Conceptual Framework Principles to Superannuation¹ Fund Accounting

The Australian accounting standard AAS 25, *Financial Reporting by Superannuation Plans*, was the first pension accounting standard internationally to apply established conceptual framework (CF) principles. In Australia those principles have guided standard setting for more than a decade. However, AAS 25 has been criticized for failing to provide useful financial information. The analysis provided in this article addresses this paradox. The findings reveal major anomalies in AAS 25 associated with the treatment of accrued benefits that distort financial position and performance measures. The conceptual flaws in the standard are attributed to the misapplication of CF principles and an absence of adequate guidance in the CF for non-corporate entities such as superannuation funds. Distorted financial information produced by superannuation plans has potential undesirable taxation and social outcomes. Consequently, there is an urgent need to update the Australian and international conceptual frameworks to provide guidance for revising accounting standards that better reflect current fiduciary and ownership relationships in non-corporate entities such as superannuation funds.

Key words: AAS 25; Conceptual framework; Pension accounting; Superannuation accounting.

In his opening remarks to the August 2002 Pacioli Society meeting, Paul Reid (2003, p. 124) stated: 'If ever there was an area of accounting standards that could be accused (and duly convicted!) of condoning outdated, irrelevant reporting, we need look no further than AAS 25, *Financial Reporting by Superannuation Plans*.' Reid's criticism of AAS 25 centres on the fact that the standard is virtually the same as when it was drafted in the late 1980s, but the industry it regulates—superannuation—and the entities within the industry—superannuation funds—have undergone a transformation over the past fifteen years (Gallery, 2003). The

¹ Overseas jurisdictions generally use the term 'pension' to refer to employment-related retirement benefits (e.g., Capalbo, 2003), whereas 'superannuation' is the term used in Australia. These terms are used interchangeably in this article.

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superannuation industry has rapidly grown as a significant sector of the Australian economy,² with increasing concerns about fund accountability and performance measurement.³ Potentially adverse consequences implicit in these concerns raise a new sense of urgency with respect to reviewing financial reporting by superannuation funds.

In some respects AAS 25 could be considered the showpiece accounting standard of its era because it was one of the first Australian standards to embrace the principles of the newly developed concept statements that formed part of the emerging conceptual framework (CF): The accounting CF was discussed in depth in the October 2003 issue of this journal. AAS 25 was also the first pension accounting standard internationally to apply CF principles. The Australian CF was developed during the late 1980s and is modelled on the U.S. Financial Accounting Standard Board CF, which was developed several years earlier and implemented in the early to mid-1980s. The Australian CF benefited by drawing on the U.S. experience to establish refined concept statements with respect to financial reporting objectives, desirable qualitative characteristics of financial information, and the definitions of elements and their recognition criteria. In 1989 the International Accounting Standards Committee (now the International Accounting Standards Board) published its *Framework for the Preparation and Presentation of Financial Statements*. As they were developed around the same time, the IASB's *Framework* is substantially the same as the Australian CF. However, the Australian CF provides considerably more explanation and guidance, particularly in Statement of Accounting Concepts 4, *Definition and Recognition of the Elements of Financial Statements*.

The accounting principles embodied in AAS 25 are therefore founded on concepts that have been applied by Australian and other standard setters for many years, and remain contemporary in the international standard-setting process. It could therefore be argued that if AAS 25 is grounded in conceptually sound accounting principles, then those principles should endure, even if the entities to which they apply have structurally changed. The question then is: Why is AAS 25 criticized for leading to 'outdated' and 'irrelevant' financial reporting if it is grounded in concepts that have guided accounting standard setting in Australia and elsewhere for more than a decade?⁴

This article addresses this question by examining whether conceptual frameworks provide adequate guidance for determining the nature and classification of

² Assets held in superannuation funds have grown from \$32 billion in June 1983 to \$534 billion in June 2003 (APRA, 2003).

³ Concerns about the management and regulation of superannuation funds, including *inter alia* disclosure by funds, motivated reviews by the Productivity Commission, the Senate Select Committee on Superannuation and Financial Services and the Superannuation Working Group during 2001.

⁴ In addition to Reid (2003), AAS 25 has been criticized by Brown *et al.* (2002), Gallery (1999, 2002, 2003), Gallery and Gallery (2003), Scheiwe (1993), Keith Alfredson, the former AASB chairman (see Davis, 2002; Mace, 2003) and the Senate Select Committee on Superannuation and Financial Services (2001).

elements in superannuation fund financial reports. Specifically, the prescribed accounting for superannuation funds in AAS 25 is contrasted with the definitions of financial report elements (revenue, expense, asset, liability, and equity) enunciated in SAC 4.⁵ This comparative approach is taken for three inter-related reasons. First, unlike pension fund accounting standards issued in overseas jurisdictions, the Australian standard is unique in adopting CF definitions and recognition criteria to justify its prescribed accounting treatment. Second, AAS 25 has wide application, covering both defined benefit and defined contribution plans. Standards issued in some other jurisdictions only address a declining number of defined benefit plans.⁶ Third, the recent exposure draft ED AAS 25⁷ proposes a revision to AAS 25 but retains the conceptual interpretation and justification for the accounting treatment adopted in AAS 25. This continued support by the Australian accounting profession raises the prospect that the conceptual approach underpinning AAS 25 may serve as a benchmark for other standard setters in revising their own pension fund accounting standards.⁸ In addition, examination of AAS 25 provides a unique opportunity to analyse the underlying CF principles as they apply to entities structured differently from corporate entities,⁹ namely, superannuation funds structured as trusts.

Our analysis suggests that differences in organizational form between corporate entities and superannuation funds have led to differences across the two types of entities in the treatment of liabilities and equity.¹⁰ In particular, under AAS 25 superannuation funds do not record equity but record a liability for accrued benefits. Employing the guidance provided in SAC 4, the analysis addresses the question of whether members' accrued benefits are in the nature of liabilities or equity. The conceptual approach adopted in AAS 25 appears to be inconsistent with the guidance provided in SAC 4. Members' interests in plan assets (accrued benefits) appear to be more like equity than a liability in nature. However, because of the lack of specific guidance in SAC 4 with respect to non-corporate entities it cannot be unequivocally concluded that accrued benefits are an equity item for

⁵ The SAC 4 definitions of the elements of financial reports are essentially the same as those in the *IASB Framework*.

⁶ See for example the U.S. standard, SFAS 35, *Accounting and Reporting by Defined Benefit Pension Plans*.

⁷ The Institute of Chartered Accountants in Australia issued ED AAS 25: Proposed Revised Australian Accounting Standard AAS 25, *Financial Reporting by Superannuation Funds*, in July 2001.

⁸ For example, the New Zealand accounting standard FRS-32, *Financial Reporting by Superannuation Schemes*, was modelled on AAS 25.

⁹ The term 'corporate entities' is used in this article to refer to public companies.

¹⁰ This element [equity] has been given various descriptions in financial reports. For example, in the private sector it has been called equity, owners' equity, shareholders' equity, equity capital, capital, capital and reserves, partners' capital, shareholders' funds, proprietorship, and ownership; in the public sector it has been called equity, public equity, contributed equity, and government equity.' (SAC 4, para. 80)

either defined contribution plans (DCPs) or defined benefit plans (DBPs). A consequential effect of treating accrued benefits as liabilities in superannuation funds is that revenues both increase assets *and* liabilities, and expenses decrease both assets *and* liabilities. This effect is in direct conflict with the SAC 4 definitions which specify that revenues (expenses) *either* increase (decrease) assets *or* decrease (increase) liabilities.

The failure to treat accrued benefits as equity has a number of important implications for users of superannuation fund financial statements. First, measures of financial performance and position based on reported data are distorted. Second, the recording of fund contributions as revenue rather than contributed equity implicitly assumes that this 'revenue' is taxable income—an interpretation currently adopted by Australian taxation authorities. These reporting distortions and taxation consequences can have social implications if they lead to sub-optimal investment and reduced retirement income.

OVERVIEW OF AAS 25

AAS 25 was one of the most debated and controversial accounting standards issued in Australia. Issued in August 1990, it coincided with attempts to implement the equally controversial concept statement SAC 4. As SAC 4 principles were employed in its drafting, AAS 25 provided an early test of the credibility of the CF.¹¹ AAS 25 (para. 13) requires each superannuation fund that is a reporting entity¹² to prepare, at least annually, a general purpose financial report and make it available to members. The standard applies to both DBPs and DCPs. AAS 25 (para. 10) defines a DCP as

a superannuation plan where the amounts to be paid to members, if they were to remain members until normal retirement age, are determined by reference to accumulated contributions made to the plan, together with investment earnings thereon.

A DBP is defined as

a superannuation plan where the amounts to be paid to one or more members, if they were to remain members until normal retirement age, are specified, or are determined, at least in part, by reference to a formula based on their years of membership and/or salary levels, and encompasses all plans other than defined contribution plans.

The distinguishing feature between the two types of plans is the method of determining benefits to be paid at normal retirement age. This distinction leads to differences in the measurement of accrued benefits and the prescribed reporting requirements.

¹¹ See Gallery (1999) for a comprehensive analysis of the development and implementation of AAS 25.

¹² A reporting entity is an entity in respect of which it is reasonable to expect the existence of users dependent on financial reports for information useful for those users' economic decision-making needs (SAC 1, para. 40). Superannuation funds that are reporting entities are those that have members who are not also trustees of the fund, that is, all funds other than self-managed funds.

CF FOR SUPERANNUATION FUND ACCOUNTING

In DCPs, accrued benefits are measured as equivalent to the net assets of the plan after deducting all other liabilities (AAS 25, para. 49). In DBPs, accrued benefits are measured as the present value of expected future payments arising from membership of the plan up to the measurement date based on actuarial valuations (AAS 25, para. 50).¹³ Irrespective of the type of plan, accrued benefits are considered a liability of the plan (AAS 25, para. 25) together with other liabilities such as income tax and sundry liabilities.¹⁴ The assets of a superannuation plan are measured at net market values and may include: contributions receivable (from employers, members and any other contributors); investments of the plan, cash and other monetary assets; and other assets, including those which are used in the operation of the plan (AAS 25, para. 27).

Revenues of a superannuation plan may include investment revenue, contributions revenue and other revenue (AAS 25, para. 29). Expenses of a superannuation plan may include benefits accruing to plan members and beneficiaries as a result of membership of the plan during the period, general administration expenses, expenses directly related to investment activities, tax expenses, and other expenses (AAS 25, para. 30). While contributions are treated as revenue, benefits paid (return of contributions and allocated earnings) are not treated as expenses in DCPs.

Thus, unlike reporting requirements for corporate entities, AAS 25 prescribes a number of unique accounting treatments for superannuation funds, including the treatment of accrued benefits as a liability item, the treatment of contributions as a revenue item, and the treatment of benefits accruing to members as an expense item. Because of these treatments, no equity item attributable to residual claimants is recognized in the accounts of superannuation plans. Consider now whether these unique treatments are conceptually sound.

HOW DOES THE CONCEPTUAL FRAMEWORK DISTINGUISH BETWEEN LIABILITIES AND EQUITY?

Several articles in the October 2003 issue of this journal noted that SAC 4 establishes a hierarchy of definitions for the elements of financial reports. Assets are defined in terms of economic benefits. Liabilities are defined in terms of future sacrifices of assets (economic benefits). Equity is defined as 'the residual interest' in the assets of the entity after deducting liabilities. Revenues and expenses are defined in terms of changes in equity arising from changes in assets and liabilities (other than those relating to contributions by or distributions to owners). Although liabilities and equity are considered mutually exclusive interests of external parties in an entity's

¹³ Any difference between DBP accrued benefits and fund net assets at measurement date represents a surplus or deficit.

¹⁴ Sundry liabilities may include accounts payable, borrowings, pre-paid contributions, forfeited benefits, amounts to be returned to employers, and amounts held as an offset to future employer contributions (AAS 25, para. 24).

assets (SAC 4, para. 82), equity is not defined independently. It is first necessary to apply the SAC 4 definition of liabilities to assess which types of interests in an entity's assets satisfy that definition, then those interests falling outside the definition of liabilities are classified as equity by default.

SAC 4 identifies two characteristics that are considered essential for a liability to exist. First, a present (legal, equitable or constructive) obligation must exist, implying the involvement of two separate parties; the entity and a party external to the entity (SAC 4, para. 51). Second, the legal, social, political or economic consequences of failing to honour the obligation must leave the entity little or no discretion to avoid the sacrifice of economic benefits to the external party (SAC 4, para. 61).

As the distinction between liabilities and equity may be obscured in practice, SAC 4 (para 95) identifies distinguishing factors. For instance, liabilities and equity differ in legal status of, and priority attaching to, the two types of claims, with liabilities ranking ahead of equity.¹⁵ A second distinction is that liabilities are generally for a stated or determinable sum, whereas an equity claim varies in accordance with the profitability or otherwise of the entity's operations. That is, equity holders enjoy the rewards and bear the losses of the entity's operations. In assuming the larger element of risk in a business enterprise, equity holders take the major share of responsibility and control of operations, whereas holders of liability securities take comparatively little risk and therefore have only slight or indirect control of the entity's affairs (Kerr, 1989). Third, the settlement of liabilities may be required on demand, on a specified date, or the happening of a specified event, whereas an entity is not obliged to transfer assets to its owners unless there is a formal declaration to make a distribution, such as a declaration of a dividend, or when the entity is wound up and remaining assets are distributed to owners. These distinguishing characteristics are summarized in Table 1.

SAC 4 neither ranks nor details the relative importance of these distinguishing characteristics across different types of entities other than to give a general

TABLE 1
CHARACTERISTICS DISTINGUISHING LIABILITIES AND EQUITY

Distinguishing factor	Liabilities	Equity
Ranking of claim to entity's assets	Above equity	Below liabilities
Exposure to investment risks and returns	Low	High
Timing of settlement of claim	On demand, on a specified or determinable date, or happening of a specified event	On liquidation of entity

¹⁵ As ranking of claims can generally only be made by reference to their legal status, legal considerations play a major part in assessing whether a claim should be classified as a liability or equity.

description of how the liability and equity definitions can be applied to profit and not-for-profit entities. But as superannuation funds are profit seeking entities with mutual fund-like attributes (Cramer and Neyhart, 1980), differences in applying the accounting concepts of liabilities and equity to these entities are likely to arise *vis-à-vis* public companies. Differences are also likely to be evident when applying the concepts within funds because of the different funding arrangements between DCPs and DBPs. These differences are expected to be reflected in the accounting treatment of accrued liabilities.

ARE ACCRUED BENEFITS A LIABILITY OR EQUITY?

AAS 25 treats members' accrued benefits (in both DCPs and DBPs) as a liability of the plan based on the following justification (para. 25):

benefits which have accrued to members and beneficiaries as a result of membership of the plan up to the reporting date constitute a liability of the superannuation plan. This is because a superannuation plan has a present obligation to transfer assets (pay benefits) to plan members and beneficiaries at a future date as a result of past transactions or other past events.

An alternative view is that members' benefits are equity in that they are analogous to the concept of residual equity held by shareholders in commercial enterprises (Cramer and Neyhart, 1980). These opposing views emphasize different liability/equity characteristics in justifying their classification; AAS 25 the 'settlement' characteristic whereas Cramer and Neyhart (1980) the 'ranking' and the 'business exposure' characteristics. Attempting to discriminate between these alternative views, the classification of members' benefits with reference to the SAC 4's myriad characteristics (Table 1) are examined and summarized in Table 2.

Ranking of Claim to Fund Assets

As superannuation funds are generally prohibited from borrowing (SIS Act, s. 76 (1)), the amounts owed by the fund to parties other than members are usually relatively small and comprise accrued expenses such as fees payable to administrators, auditors and other service providers. In the event of winding up of the fund,

TABLE 2
CHARACTERISTICS OF ACCRUED BENEFITS IN DBPS AND DCPS

Distinguishing factor	DCPs	DBPs
Ranking of claim to fund assets	Below liabilities	Below liabilities
Member exposure to investment risks and returns	High	Low
Timing of settlement of claim	Retirement or prior unspecified date	Retirement or prior unspecified date

all amounts owing to creditors would have to be settled before any distributions to members. Accordingly, members are ranked last, having the residual interest in the net assets of the fund in the same way as equity holders in a business enterprise.

Exposure to Investment Risks and Returns

In the case of DCPs, members' benefits are derived from two sources: 'capital' contributions and investment earnings on that capital. Accordingly, DCP members, like corporate shareholders, bear the investment risk and enjoy the rewards arising from the fund's investing activities. As a result, members' claims cannot be determined independently of plan assets and liabilities. In DBPs these risks and rewards reside with the employer-sponsor because members' benefits are determined by a pre-set formula. The employer-sponsor agrees to provide benefits on employee retirement and therefore underwrites the actuarial and investment risks associated with DBPs (IASC, 1996) because the employer has an obligation to provide the benefits regardless of the earnings performance of the fund (Archibald, 1980). However, if a member ceases employment prior to becoming eligible to receive a defined benefit, the benefit payment is restricted to the member's vested benefits, which typically include a return of contributions and associated investment earnings. As is the case in DCPs, it is the departing member not the employer who is exposed to the investment risk. Where DBP members work until normal retirement their accrued benefits can be likened to a fixed claim which cannot be determined precisely until near or on settlement date.

Timing of Settlement of Claim

Under SAC 4 (para. 63) settlement of obligations may be required on demand, at a specified date or on the happening of a specific event. In both DCPs and DBPs, the trustees have no discretion to avoid paying benefits when they fall due on the specified retirement date of the employee, or earlier under certain circumstances (e.g., resignation, disability, death). Consistent with the SAC 4 definition of a liability, the fund has little or no discretion to avoid settlement. This fixed claim on settlement differs from the equity claim of corporate shareholders, in that fund members have a right to claim their share of plan assets on cessation of employment, whereas shareholders cannot demand their share of assets unless the company is wound up.

The analysis reveals that both DCP and DBP accrued benefits display a liability-like characteristic arising from the unavoidable obligation of the plan trustees to settle claims at a determinable date, but they also possess an equity-like characteristic of ranking below liabilities in the settlement of claims. A distinguishing feature between the two types of plans relates to the exposure to investment risks and returns. While DCP members are exposed to variability of investment performance, DBP members are not generally exposed to this equity-like characteristic.

Taken together, application of the SAC 4 guidance on the liability-equity distinction appears to indicate that, contrary to the liability classification of accrued benefits in AAS 25, accrued benefits possess many equity-like characteristics.

However, due to insufficient guidance in SAC 4, it is not possible to classify accrued benefits unequivocally as a liability or an equity item. In an attempt to clarify the classification issue, the AAS 25 treatment of the changes in accrued benefits is next contrasted with the SAC 4 treatment of revenues and expenses.

ARE CHANGES IN ACCRUED BENEFITS REVENUES/EXPENSES?

The SAC 4 definitions of revenues and expenses are linked to the definitions of assets and liabilities in that revenues increase equity and either increase assets or decrease liabilities, and expenses decrease equity and either decrease assets or increase liabilities. Revenues arise once the entity has control over the future economic benefits (assets), provided that there has not been an equivalent increase in liabilities (SAC 4, para. 114). Hence according to SAC 4, revenues either increase assets or decrease liabilities, but not both.

In contrast, AAS 25 treats revenue as increasing both superannuation fund assets and liabilities. That is, because AAS 25 treats accrued benefits as a liability, the effect of recognizing revenues is to increase assets and at the same time *increase* liabilities (accrued benefits), while expenses decrease assets and *decrease* liabilities. These contradictory effects and the absence of 'equity' render the SAC 4 definitions of revenue and expense inoperable in the context of accounting for superannuation funds.

A further inconsistency between AAS 25 and SAC 4 is that AAS 25 (para. 25) treats contributions as revenue when they are more in the nature of capital amounts. As contributions are made by members (or on their behalf by employers), they are 'owned' by members and therefore represent transactions with owners. Given that the SAC 4 definition of revenue specifically excludes 'capital contributions by owners', contributions to superannuation funds made by members, or by employers on behalf of members,¹⁶ fail to meet the definition of revenue. Contributions are made with the intent of earning a return on investment; they are therefore more likely to represent increases in equity. As noted in SAC 4 (para. A89), where 'contributions are provided with the expectation of receiving a desired rate of return, and the contributor possesses rights relating to distribution of future economic benefits by the entity... contributions would be identified as equity.'

While AAS 25 treats contributions as revenue (a line item in the operating statement), reductions in accrued benefits in the form of benefit payments to DCP members are not treated as expenses. Rather, benefits paid to members are an adjustment against the 'Liability for Accrued Benefits at beginning of period' (see Note 2 to AAS 25, Appendix 1) and are in effect a capital adjustment. This capital adjustment treatment is inconsistent with AAS 25's liability treatment of contributions but is consistent with SAC 4's (para. 144) equity classification of

¹⁶ Employer contributions to superannuation funds are contributions made indirectly by members (or the 'contributors') as they represent employee entitlements. That is, the superannuation contributions made to the fund by the employer are a substitute for wages that would have otherwise been paid to employees.

'distributions to owners' (as a return on investment or as a return of investment). Overall, the analysis of the AAS 25 treatment of the changes in accrued benefits relating to contributions and benefit payments reinforces the conclusion that accrued benefits are inappropriately classified as liabilities instead of equity.

IMPLICATIONS OF MISCLASSIFICATION AND ABSENCE OF CONCEPTUAL GUIDANCE

According to the CF, the objective of financial reports is to 'provide information useful to users for making and evaluating decisions about the allocation of scarce resources' (SAC 2, para. 43). Given the lack of guidance in the CF about non-corporate entities, it is questionable whether this objective is being achieved. The inconsistencies and failure to provide adequate guidance have a number of significant implications.

First, an implication of treating contributions as revenue and benefits paid as an adjustment against the liability for accrued benefits is that the operating statement of superannuation funds mixes operating income and capital items. The 'bottom line' reported in the Operating Statement of a DCP (AAS 25, Appendix 1) is termed 'Benefits Accrued as a Result of Operations'. These benefits are measured as 'the difference between revenues and direct investment, general administration, income tax and any other expenses incurred during the reporting period in generating benefits for plan members and beneficiaries' (AAS 25, para. 54).

This bottom line amount represents the fund's net income for the period. Two widely held views about the nature of income are that it is (a) an enhancement of wealth or command over economic resources, or (b) an indicator of performance of an entity and its management (Storey and Storey, 1998). The first view is generally attributed to Hicks' (1939) concept of income as a change in 'well-offness'. It treats income as a change in the financial position of the entity, that is, changes in equity that result from activities other than transactions with owners. This 'capital stock' view of determining income contrasts with the alternative 'capital flows' view where profit is calculated as the difference between revenues and expenses (Henderson *et al.*, 1992). The latter view focuses on the proper matching of those revenues and expenses (Riahi-Belkaoui, 2000). None of these views of income is presented by a superannuation fund's operating statement prepared in accordance with AAS 25 because the bottom line reflects neither the change in wealth nor the operating performance of the fund. Exclusion of benefits paid and inclusion of contributions received means that the net income is not an indicator of the change in wealth and therefore cannot serve as a useful proxy of fund performance.

Fund members, particularly those in DCPs, would be interested in the financial performance ('profitability') of the fund, that is, how well investments of assets have been managed in generating returns to increase benefits. Assuming 'financial performance' is defined as 'all recognized (recorded) changes in equity other than those resulting from transactions with owners in their capacity as owners' (Johnson and Lennard, 1998, p. 4), then contributions should be excluded to avoid obscuring

the plan's financial performance.¹⁷ Furthermore, as trustees do not determine the rate or timing of contributions to the plan, it is inappropriate to include contributions received by the DCP in the determination of trustees' financial performance.¹⁸ The bottom line of a DCP's Operating Statement, termed 'Benefits Accrued as a Result of Operations' by AAS 25, does not reflect a fund's financial performance because it is distorted by the inclusion of capital contributions.

Second, an implication of reporting accrued benefits as a liability rather than as an equity item is that financial statements produced under AAS 25 will not clearly convey information about the financial position of superannuation plans. Therefore a fund's control over resources, its financial structure, and its capacity for adaptation and solvency will not be obvious. In combination with the misclassification of contributions, returns on investment indicators are not readily determinable. Ultimately these distortions hinder the ability of trustees to discharge accountability to members.

Third, superannuation contributions are also treated as revenue for tax purposes.¹⁹ The continuing requirement of AAS 25 to account for contributions as 'revenue' may reinforce the taxation authority's and government's widely criticised position that contributions represent taxable income. Contributions from members and employers are by nature risk capital and that essential characteristic does not change just because the government imposes a tax on those monies when received by superannuation funds (Reid, 2003). The treatment of contributions as taxable income for taxation purposes could also have provided advocates of the AAS 25 view with further justification for treating contributions as revenue for accounting purposes.

Fourth, the combination of distortion in reporting financial performance and position, accountability concerns and taxation consequences can have social implications if they contribute to sub-optimal investment and reduced retirement income. Indeed much of the current policy debate about the adequacy of superannuation investments to provide retirement incomes relates to concerns about performance measures, governance and taxation issues.²⁰

CONCLUSION

This article has reviewed the application of the CF to accounting for superannuation funds. Employing the guidance provided in SAC 4, the analysis has addressed

¹⁷ Cramer and Neyhart (1980) similarly argue that commingling income with other unrelated changes in plan assets (contributions and benefit payments) in a statement of changes in net assets available for benefits obscures the plan's operating performance.

¹⁸ Regardless of whether accrued benefits are classified as liabilities or equity, contributions represent capital amounts that are deposited with the DCP, and returned to members (intact or otherwise) when they become entitled to payment.

¹⁹ As per the *Income Tax Assessment Act* (Pt. IX).

²⁰ For example, see Senate Select Committee on Superannuation and Financial Services (2001).

the question of whether members' accrued benefits are in the nature of liabilities or equity. The conceptual approach adopted in AAS 25 appears to be inconsistent with the guidance provided in SAC 4. Members' interests in plan assets (accrued benefits) appear to be more like an equity than a liability item. However, because of the lack of specific guidance in SAC 4 with respect to the liability/equity distinction for non-corporate entities we cannot unequivocally conclude that accrued benefits are an equity item for both defined contribution plans (DCPs) and defined benefit plans (DBPs). The recent experience with ED AAS 25 reinforces this conclusion in that the exposure draft retains the existing classification of accrued benefits as a liability. Although a number of lobbyists on ED AAS 25 identified CF-related flaws in the exposure draft, there was no clear consensus of views and neither the accounting profession nor the AASB has issued a revised version of the standard which addresses these flaws.²¹

The Australian standard setters' unprecedented decision to treat accrued benefits as superannuation fund liabilities is also significantly out of step with the approach to pension accounting taken by standard setters in other jurisdictions. In developing SFAS 35, the FASB grappled with the question of whether DBP members' accrued benefits should be presented in financial reports as a liability or an equity interest, or excluded from the report altogether and disclosed as supplemental information (SFAS 35, para. 223). Widely divergent views were put to the FASB by lobbyists on the question of whether accrued benefits are a liability or equity item. These views and the lack of consensus on this question among board members led to the FASB's conclusion that the issue did not need to be resolved at that time (SFAS 35, para. 231).²² The FASB's decision to defer the resolution of the accrued benefits classification issue is likely to have been influenced by an absence of a concept statement defining the elements of financial reports.²³ Similarly, the Canadian Institute of Chartered Accountants chose not to resolve the accrued benefit classification issue in issuing their U.S.-based pension accounting standard in 1984 (CICA, 1984). The classification of accrued benefits did not arise in the development of the U.K. pension fund standard because it was determined that information about accrued benefits is the province of actuarial reports and should be excluded from pension plan financial reports (ASB, 1995).

International Accounting Standard, IAS 26, *Accounting and Reporting by Retirement Benefit Plans*, presents three options for reporting accrued benefits: recognition on the face of the financial report, disclosure in the notes, or including them in an actuarial report. All three methods are acceptable under IAS 26,

²¹ Subsequent to closure of the comment period on the exposure draft in November 2001, the ICAA submitted a revised version of AAS 25 to the AASB for consideration. To date the AASB has not indicated intentions with regard to the ICAA submission.

²² Contrary to Klumpes' (1994, p. 145) claim that the Australian standard setters followed the FASB's approach to SFAS 35 in treating accrued benefits as a liability of the pension fund, the FASB had *not* made a decision on this issue.

²³ SFAS 35 was issued in 1980 and the Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, in 1985.

provided that in the third case, the financial report contains reference to the accompanying actuarial report (para. 31). Although IAS 26 acknowledges varying views on whether promised retirement benefits have the characteristics of a liability, and whether it is appropriate to directly compare the actuarial present value of benefits with plan assets, the standard does not address the accounting nature of accrued benefits. By allowing three options for reporting accrued benefits, IAS 26 effectively accommodates each of the approaches taken in the domestic accounting standards of the U.S., Canada, the U.K. and Australia.²⁴

Despite the broad approach to pension fund accounting in IAS 26, the AASB has not included IAS 26 and AAS 25 in its 2005 international convergence program.²⁵ The AASB's justification for this exclusion is that these standards 'cover a topic that could be regarded as being purely of domestic interest, particularly in view of the substantial impact of domestic regulation on superannuation plans' (AASB, 2003). The rejection of the international standard IAS 26 due to domestic interests is inconsistent with the AASB's general strategy to adopt IASB standards and accommodate Australian legislation (e.g., Corporations Act) by changing the wording in the standards to allow for domestic legal requirements but without affecting the substance of the standards. These disparate approaches further highlight the absence of definitive principles in the area of the accounting for superannuation/pensions entities.

Conceptual uncertainties clearly impede attempts to address increasing concerns about superannuation fund accountability and performance measurement. Our analysis suggests that existing conceptual frameworks do not provide sufficient guidance in contexts outside the 'norm' where the reporting entity is neither a corporation nor a not-for-profit organization. To address these uncertainties, CFs need to be updated to better reflect the current fiduciary and ownership relationships in superannuation/pension funds. Further, there is need to issue a revised superannuation/pension fund accounting standard, which is both internally consistent and consistent with revised frameworks. Although the AASB has flagged AAS 25 for review by placing it on the board's work program, timing of that review has yet to be determined.²⁶ We recommend that the AASB give priority to reviewing AAS 25, given the significance of superannuation in the Australian economy. We also urge Australian standard setters to work towards an international solution, as many of the conceptual anomalies identified in this article are evident in the CFs and superannuation/pension fund reporting standards of the IASB and other jurisdictions.

²⁴ It is interesting to note that, of the four countries, only the Australian accounting standard (AAS 25) has mandatory status. The U.K. SORP 1 and Canadian Section 4100 are recommended practice statements only, and the U.S. SFAS 35 is mandatory only if the pension plan purports to prepare financial statements in accordance with generally accepted accounting principles.

²⁵ In July 2002 the AASB oversight body (the Financial Reporting Council) announced that Australia will adopt IASB standards by 1 January 2005.

²⁶ See 'Australian Accounting Standards Board Work Program for the coming year as at July 2003' at http://www.aasb.com.au/workprog/aasb_workprog.htm.

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Notes of the University of Sydney Pacioli Society

THE UNIVERSITY OF SYDNEY PACIOLI SOCIETY MEETING ON 29 APRIL 2003

STOCK-BASED COMPENSATION AND CORPORATE GOVERNANCE

Ladies and gentlemen, good evening. It is quite some years since I attended a meeting of the Pacioli Society so I am especially pleased to be here once again.

Stock based compensation is a contentious topic. Tonight I will cover some important issues that came up in a symposium on executive incentive plans that I helped organize in London in January this year.¹ Many accounting matters were canvassed at the symposium, which had a special focus on ED 2, *Share-Based Payment*, issued by the International Accounting Standards Board (IASB). In a little while I will touch on some of them, such as the approach taken in ED 2 to reach its conclusions, inconsistencies between ED 2's proposed treatment of executive share options (ESOs) and how they are regarded by investors, economic consequences if ED 2 becomes an accounting standard, and some challenges for the IASB in the years ahead.

As important as the accounting issues are—the symposium was timed to allow feedback within the ED 2 comment period—the discussion ranged more widely. So before I get on to the accounting issues, I will comment on three others that have a bearing on the use of share-based payment. They are: (a) share options' incentive effects, (b) institutional investors' attitudes to executive share options, and (c) directors' limited understanding of how options work and can be priced.

Share Options' Incentive Effects

Options can improve the alignment of shareholders' and managers' interests but they can also make it worse. On the positive side, Hanlon *et al.* (2002) estimated that 'a dollar of Black-Scholes value of an ESO grant' leads to \$3.82 in future operating income to U.S. firms. Options also provide what are believed to be much-needed incentives for managers to take on desirable risk. That's what options can do best: They are fundamentally instruments for efficiently 'managing' risk.

Because the negative aspects of options are not so well known and to balance the argument over the merits or otherwise of ESOs, I will mention some examples

¹ A briefing paper on the symposium may be downloaded from <http://www.icaew.co.uk/cbp>

of imperfect alignment: managers' use of their private information, their incentives to take risk, their influence on corporate financial policy, and differences in ESOs' worth to the manager and their opportunity cost to the firm.

The first example of imperfect alignment is the incentives that options provide for executives to exploit their information advantage. Aboody and Kasznik (2000) concluded managers suppress stock prices by releasing bad news and withholding good news in the lead-up to an option grant—so that options granted at-the-money become exerciseable at a lower price. Carpenter and Remmers (2001) found that top managers of small firms tend to exercise their ESOs and sell the stock ahead of a share market decline. The clear implication is that boards' remuneration committee members need to understand that managers do have private information, which they may use to their advantage in compensation negotiations.

A second example is risk-taking. Most would be familiar with the 'Hubris Hypothesis', which ascribes the disappointing long-run share market performance of bidders in takeover contests to managerial grandstanding. Similarly, option grants can lead to reckless takeovers—according to Ken Peasnell, one of the speakers at the symposium—because, other things being equal, greater risk translates into more valuable options.

My third example lies in the realm of corporate financial policy: dividends and borrowing decisions. In practice, options typically are not protected against the firm paying a dividend, though they can be (Arnold and Gillenkirch, 2002). So an interesting question is whether the growth in ESOs has contributed to the secular decline in the frequency of dividend payments by U.S. listed companies (Fama and French, 2001). Baker and Wurgler (2003) studied this question. They concluded that, while 'stock options and repurchases have . . . *propagated* the post-1978 disappearance' of dividends in the U.S., 'there is no evidence that [they] *initiated* that decline' (emphasis in original). As for debt, Sanning (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=394600) found that executive options lead to added financial risk taking only when there is a low level of institutional ownership. Others (e.g., Choe, 2001) have taken the view that, in principle, the incentive for executives who hold options to increase financial risk can be managed by appropriate structuring of the terms of the option grant. But have directors been that prescient?

My final example of misalignment comes from the well-known difference between the value executives place on ESOs relative to their opportunity cost to the firm. The difference is due to some firm-related residual risk being borne by the executive who holds the options. Because that risk is not reflected in the options' cost to the firm, managers typically consider options are worth less to them than they cost their employer. The difference between these two values can be large. Lisa Meulbroek (2001) has estimated it is 30 per cent of the options' market value for 'managers at the average NYSE firm who have their entire wealth invested in [their] firm' and almost 50 per cent for 'undiversified managers at rapidly growing, entrepreneurially-based firms'.² Investment banks have noted this

² From an accounting viewpoint, the relevant value of ESOs is their larger cost to the firm, not their smaller worth to the executive or employee.

disparity. A number of them have been disingenuous in offering to buy the options from the executives at their full Black-Scholes option value—thereby eliminating the risk-bearing incentive that the ESOs presumably were intended to provide.

Institutional Investors' Attitudes to ESOs

Institutional investors in the U.K. have wished to see others share the pain of the prolonged U.K. bear market. They are the main reason why smaller companies have been unable to use options more recently. They've opposed the cancellation and re-issue of outstanding options that are deeply out-of-the-money. And many small to medium size U.K. companies have hit the traditional 10 per cent cap on options (that is, options cannot exceed 10 per cent of the issued shares) so they are unable to issue any more. That does not mean, though, that knowledgeable boards could not have used option-like incentive contracts to achieve much the same effect.

Institutional investors in the U.K. have been pressured by government to be more proactive on corporate governance matters, and they are responding. Evidence is to be found in their use of corporate governance consultants and data providers, such as Manifest Information Services Ltd. Anita Skipper, of Morley Fund Management (which in January 2003 managed portfolios worth about \$A500 billion), outlined to the symposium how major U.K. fund managers such as Morley keep abreast of developments in executive remuneration and corporate governance practices by sharing information, and by voting their U.K. shares at all meetings of shareholders.

In Australia, the Corporations Amendments (Repayment of Directors' Bonuses) Bill was amended in the Senate earlier in 2003. The amendments would have required companies to publish details of their board policy on executive remuneration, trustees of large superannuation funds to vote their shares and disclose their voting records, and fund managers to disclose their voting records. Although the House of Representatives subsequently rejected the amendments, they were referred to a parliamentary committee for investigation. It is likely that further political pressure will be applied to Australian institutional investors, to encourage if not require them to play a more active role in corporate governance matters. It is of course debatable whether that pressure will make much sense to the managers of index funds.

Directors' Limited Understanding of Options

Because of their complexity, options are not well understood by most company directors. Indeed, we might well wonder whether board-level ignorance could have created ideal conditions for some self-serving executives, who do understand their value, to try to 'steal a good part of the farm' from right under the directors' noses.

We must also wonder how well boards have understood that even 'well out-of-the-money' options are not necessarily without merit. Jin and Meulbroek (2002) make the point that 'over the course of the year 2000, a year that for many firms marked the derailment of the long-running bull stock market... the ability of options to align incentives remained remarkably intact'. They put this down to the long lives of ESOs and the higher volatility that accompanied the market decline.

However, even if options have retained a substantial part of their incentive effect, boards still need to be sensitive to the impact on managers' wealth of declining values of executive options and the fact that the impact has not been uniform across all sectors.

Peter Brown, chairman, Independent Remuneration Solutions, argued at the symposium that boards' remuneration committees in particular need education on the proper use of ESOs. Importantly, they need access to independent advice. Too often they are advised on ESO grants by a remuneration consultant who faces a conflict of interest. The conflict arises when senior executives who will receive the grants appoint the consultant to advise them on a whole range of remuneration questions at other levels within the firm.

Accounting for Share-Based Payment

Against the foregoing backdrop, and especially since this is a meeting of the Pacioli Society, in the time remaining I should move on to some specifically accounting issues. I will focus on ED 2, covering ED 2's over-arching approach, apparent inconsistencies between ED 2 and how financial markets regard ESOs, some 'leftovers' from the ED 2 project that will need attention by the IASB, and some future challenges for the IASB.

ED 2 takes a conceptual approach. It can be illustrated by reference to the disparity in the proposed treatment of ESOs and share appreciation rights (SARs), which came under the spotlight at the symposium. The disparity is that ESOs would be recorded over the vesting period based only on their value at the grant date, whereas SARs would be recorded at their value on the grant date and subsequently marked-to-market. The basic argument in ED 2 proceeds as follows. Under the conceptual framework, equity is never re-measured. Options are equity. Therefore options are not re-measured. SARs are debt. Debt is re-measured. Therefore SARs are re-measured. The IASB decided to live with the consequences of applying its existing conceptual framework, which led to the conclusion that ESOs and SARs should be treated differently, despite their substantive similarities. But it is committed to re-visiting the definitions of the elements (equity, liability) that led to this apparent inconsistency.

There are other potential inconsistencies to note. Wayne Landsman presented evidence to the symposium that ED 2 is inconsistent with how investors regard ESOs, on at least three grounds. First, ED 2 would not recognize an asset (other than indirectly, as when the options are granted to employees whose remuneration is capitalized into say inventory or R&D); instead, the accounting entry would be to debit compensation expense and credit options outstanding, thereby accruing the options' fair value over the vesting period (see ED 2 for details.) Yet there is clear evidence that the share market regards an issue of ESOs as a means whereby the firm acquires a long-lived intangible asset, perhaps reflecting the employees' knowledge or sense of commitment to their employer. Second, ED 2 proposes to measure the option component of employee compensation expense over too short a time period, in that some of the ESOs' implied asset value remains on the vesting date and therefore would be expected to be expensed in periods beyond that date.

Third, Wayne Landsman noted he has found at least some evidence that the market considers options are debt, not equity, in which event the definitional elements underlying the conceptual framework are inconsistent with how investors regard the statements that are prepared for them and other users. It is of course true that the kind of study Landsman has conducted is only one of many aspects that standard setters must consider when reaching their conclusions.

There are some 'leftovers' from the ED 2 project that will need attention by the IASB if ED 2 gets across the line—which, despite the general support for ED 2 at the symposium, is by no means guaranteed. I've already referred to one, namely re-visiting the conceptual framework, given the apparent inconsistency between the treatment of ESOs and SARs. Another is to be considered as part of the IASB's project on the statement of operating performance. Security analysts distinguish between earnings from core activities and 'non-core' earnings resulting from financial engineering and other decisions. Analysts will be seeking more detail than is currently provided in the financial statement presentation of items relating to ESO grants. They will need this information if, for example, they first value equity as a whole and then apportion the aggregate value to the ESOs and underlying shares. Analysts' assessments of the current values of ESOs, made this way, could be far removed from the figures that accountants would provide if ESOs were marked-to-market in the financial statements.

Regardless of the IASB's conceptual approach, accounting standards remain the outcomes of a potentially highly charged political process. As we all know, alternative accounting treatments can have serious economic consequences. How else can we explain the vehement opposition of American business to the FASB's 1993 ED and its continuing opposition to the IASB's ED 2 ten years later? Presumably those consequences also help explain why U.S. option plans rarely have had performance hurdles, and why some U.S. portfolio managers have taken a view, on appropriate reporting requirements for ESOs, that differs from the views expressed by their corporate counterparts. Macroeconomic consequences would follow from the cancellation of broad-based share plans if ED 2 is adopted without exempting such plans. The threat of 'no exemptions' could help explain why some EU politicians, who have a special interest in widening share ownership in Europe, are opposed to ED 2.

Interestingly (to me, at least), about a third of the almost 250 ED 2 comment letters currently posted on the IASB web-site are sourced from the U.K., 20 per cent are from other European countries and another 20 per cent from the U.S.A., about 6 per cent are from Australia and New Zealand, and the remainder come from a range of countries around the globe. While the IASB must be encouraged by the wide geographic spread of the letters' sources, a major challenge in the years ahead for the IASB will be how its influence and viability, which will be linked to the 'legitimacy' of international accounting standards, can be maintained in a global, political environment; one where each nation or nation state retains sovereignty over its own commercial affairs, and where previously influential participants in the political process foresee a continual weakening in their capacity to influence outcomes.

Meanwhile, in Australia, we press on with the move to adopt IFRSs in 2005.

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PACIOLI SOCIETY NOTES

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On Brian P. West's *Professionalism and Accounting Rules*

'The primary aim of this study is to demonstrate that present accounting rules do not yield serviceable financial information and that expertise in interpreting and applying those rules does not substantiate a cognitive authority of the kind expected of a professional occupation' (West, 2003, p. 8).¹ Indeed, a 'preoccupation with accounting rule-making and rule-compliance has distracted attention' (p. 1) from questions regarding the 'serviceability of the financial information yielded by the application of those rules' (p. 7). 'To elevate rule-compliance to the apex of accounting—as is now common in accounting practice, discourse and education—is to elevate the means over the end they purport to serve; to privilege process over purpose' (p. 1).

This distillation from West's first chapter introduces us to the richness of his remarkable book. A study of subject matter such as accounting rules, serviceable financial information, the cognitive authority of a profession, and the impact of rules on accounting practice, discourse (research), and education promises attention to matters of importance to accountants in general. West delivers—and throws in careful consideration of the meaning and interrelationships between a profession's authority, its responsibility, and its independence. He has raised the most provocative set of questions regarding accounting that I have seen in recent decades. His study, a dissertation at Deakin University under the expert guidance of Peter Wolnizer and the late Ray Chambers of Sydney, is the most carefully reasoned case for a principles approach to setting accounting standards that one could hope for. In fact, it deals with ideas so fundamental that they provide a basis on which principles can rest.

It is a privilege to have the opportunity to write about the most 'notable contribution to the literature of accounting' that I have seen for several decades. I thank Graeme Dean for inviting me to do so without space limitation. Every chapter deserves careful attention, so I shall proceed in West's order.

Chapter 1, Matters in Conflict, introduces us to many of the concerns explicated more fully in later chapters. The heart of his case is a lack of connections between (a) accounting rules and the rule-making process, (b) professionalism, and (c) the function of accounting as a service to society. What is a profession? Is accounting a genuine profession? I won't tell you 'who done it'; you should read the book to

¹ B. West, *Professionalism and Accounting Rules*, Routledge, 2003, x + 242 pp., £65.00, ISBN 0415285690.

find out. I will tell you, however, that Mr West has serious doubts as to whether the present standards-setting course in the worldwide profession is strengthening the authority and independence of accountants and the value of their services.

West makes it clear in the beginning that he is a member of the Sydney school of thought. Ray Chambers is the source he turns to most frequently. Thus, accounting is an instrument that should guide actions in financial affairs in ways similar to those of instruments in motor vehicles and aircraft. If they fail to convey the measurements that operators need and think they are getting, avoidable crashes are bound to occur. An account of an event or circumstance is a description. If an enterprise's financial affairs are of concern, correspondence with commercial phenomena is the determinant of the usefulness (serviceability) of accounts, as without a grounding in the real world of today's commerce an account cannot be relevant to financial decisions pertaining to that commerce, and without correspondence reliability is lacking. West does not, however, address the matter of identifying the decisions for which the accounts might be useful, presumably on the grounds that they vary, are personal, and so on. In this regard, he diverges from the mainstream versions of decision-usefulness theory, which clearly identify the decisions of investors (owners and creditors) and others calling for evidence of the enterprise's future cash flows as the focus of financial reporting. In this, he is true to the Sydney tradition.

IS ACCOUNTING A PROFESSION?

Chapter 2, Professions, is concerned with the nature, roles and responsibilities of professions. West displays evidence of considerable study of the sociology of professions and refers us to many relevant sources. 'It is the objective of this chapter to establish an understanding of professions that transcends the current discord in the literature and which will inform this study' (p. 13). He accomplishes that objective, thus forming a base on which to examine the professional status of accounting. After a lengthy review of many views, he nominates '*elevated occupational authority* . . . [as] the most important evidence and consequence of the professionalization of occupations . . . members of professionalized occupations enjoy largely exclusive authority to provide certain services and define the nature of those services' (p. 40, emphasis added). Only physicians, dentists, nurses, architects, engineers, and so on know how to and are entitled to practise their occupations. A profession's knowledge base and entitlement typically are recognized in law. Thus, only certified or chartered accountants are permitted to perform audits of public companies, and those privileged individuals have provided evidence of their mastery of the appropriate knowledge base.

West considers the (possibly altruistic) motives of professionals, their social status and their incomes as possible evidence of professional status, but rejects them. Instead, he emphasizes (a) a knowledge base and (b) effectiveness of technical practices in accomplishing objectives related to serving those members of the public who seek professional services. A construction engineer knows how to build a structure that will stand and serve; a dentist has the special ability to care for a

patient's teeth. Why she has chosen to study and practise dentistry, her income, or her standing in the community are not determinants of professional status.

Chapter 3, Accounting as a Profession, goes into the question of whether accounting is a profession. In Chapter 2, West established elevated occupational authority as the key mark of a profession. Here he looks at accountants' own representations, findings of independent parties, and 'primary evidence that is indicative of occupational authority' (p. 42). Each search turns up evidence of professionalism but the third search is the most conclusive. In particular, the exclusive rights given to the auditing branch by statutes and regulations accompanied by auditors' freedom to conduct their work almost entirely free of any externally imposed regulatory framework pertaining to how the audit is to be conducted are convincing.

Here West is concentrating on the criterion of elevated occupational authority. If one disagrees with that criterion or believes it requires supplementation, other questions might be raised pertaining to the professionalism of accounting: (a) Does accounting give priority to serving people seeking help over the profitability of its business? (b) Does accounting enquiry seek understanding of how to serve society? (c) Do accountants connect their prescriptions to the needs of the presumed beneficiaries? (d) Is accounting practised primarily as a knowledge-based profession or as a rules-based profession? The possibility that answers to these questions might suggest a different answer to the profession question is always before us.

The chapter continues with an investigation into the origins of the occupational authority enjoyed by accountants. Two possible explanations are examined: social awareness and intellectual. Social moves that were identified included alliance with other professions, especially law, exclusion of women to elevate income expectations, erection of barriers to entry, and association with the gentry. These strategies were found to be significant in gaining specialized occupational authority for accountants.

West had more difficulty justifying the professional status of accounting on the grounds of accounting knowledge. One might argue that the most impressive core of knowledge that has separated accountants from all others for centuries has been the mysteries of double-entry bookkeeping. But a set of people with that core knowledge existed for hundreds of years before they achieved 'elevated occupational authority', starting in nineteenth-century Scotland. Only when they banded together to make the social moves mentioned above did they gain such authority. If this version of history is accepted, one might conclude that shrewd social manoeuvring played a larger role than a unique knowledge base in accountants' achievement of professional status.

Here is West's conclusion:

[W]hile it is clear that accountants exercise substantial authority within the domain in which they operate, it is not clear that the origin of that authority lies in cognitively based expertise. Instead, there is abundant evidence of a social process surrounding the professionalization of accounting. It reveals that the social class, gender and political acuity of early accountants contributed to the elevation of accounting within the occupational continuum, assisted by changes in the legislative and economic environments. Developments in accounting knowledge—particularly in connection with the financial reporting function where accountants' authority has been especially evident—are less easily identified as an explanatory factor. (p. 63)

At this point, however, West invites controversy by asserting that ‘the adoption of a coherent framework for *reporting* the financial position and results of firms—that is, a functional system of financial instrumentation—has not been in evidence at any time since “professional” accountants ascended to a position of authority’ (p. 63). If this is interpreted as relating to the accountants’ rule book in practice, many would agree. If, on the other hand, it refers to the conceptual framework that has been established by standards setters in the last thirty years, the word ‘coherent’ is key, and contentious. But pursuit of that issue is not necessary for West’s case. The conceptual framework is not generally accepted by practitioners and has had limited influence; GAAP is what counts, and the literature of accounting includes no coherent framework for it.

RULES

Chapter 4, The Nature of Accounting Rules, is critical. Without serious thought about this matter, we are in no position to discuss most of the issues in the book. Because ‘Technical accounting rules now exert a dominating influence on the practice of accounting’ (p. 66)—by both preparers and auditors of financial reports—and in teaching, enquiry regarding their nature can pay off handsomely. To my knowledge, there have been few objections to the ‘cookbook’ characterization of the accounting standards of recent years—especially those of the FASB.² It is altogether fitting that someone should question whether that approach is ‘suggestive of a procedural activity without an intellectual foundation’ (p. 66). The current study in standards-setting circles of the value of that approach as compared with a principles approach is to be welcomed.

Description of the body of GAAP (and similar sets of guidance) as a cookbook need not be overstated. We need not object to recognizing some parts of it as principles—the realization principle, for example. The point is that a substantial and increasing portion of what must be applied by preparers and auditors of financial statements consists of detailed guidance that is properly described as rules. West questions whether the whole bit, rules or not, represents a body of professional knowledge.

Knowledge is described as justified true belief where truth requires correspondence with observable independent evidence as well as the internal consistency, or coherence, of a set of true statements. West sees GAAP as failing on both counts. These serious defects in our rule book are widely understood, as is the political basis for standards setters’ failure to repair them. When different components of a line item, such as inventories held for sale, are reported at a variety of dated market prices, some in entry markets, others in exit markets; when the monetary measuring unit used varies in size; when a group’s total assets include the excess of the market value of one member of the group over the values assignable to its specific assets when acquired (goodwill) but does not include such a difference for other members of the group, where is the internal consistency of the balance

² Some exceptions include Kay and Carsberg (2002) and Clarke *et al.* (2003, p. 19 and related notes 51 and 52).

sheet? What do the summary numbers on the balance sheet and income statement mean? The profession makes no effort to answer such questions. This complaint need not be belaboured, but West would have been negligent to ignore it.

West also applies the concept of consistency to matters other than internal consistency. One is what he calls correspondence with commercial phenomena. It is not clear why he avoids the term 'economic' here; indeed, from my point of view his tendency to neglect economics and finance is a significant limitation in his work, although it does not seriously impair his message regarding professionalism and accounting rules. So let 'commercial' stand. This is the standard Sydney complaint that is familiar to, and generally accepted by, observers of accounting theory literature. Its essence is that dated financial statements are replete with measurements from other dates and also include results of accountants' calculations not based on market prices observed on any date, such as unamortized costs of intangibles reported as assets and their amortization as expenses. My own guess is that readers who do not agree with this criticism will not finish the book, but I suggest that they at least take a look at Chapter 9.

Another serious weakness in the rule book that West puts under the consistency heading is the lack of consistency between accounting rules and the function of accounting. 'The function of accounting pertains to the provision of information that facilitates informed human action. The justification for the existence and enforcement of accounting rules can only proceed from a demonstration of how those rules serve that function' (p. 69). This lack of connections between rules and the usefulness of the financial statements surely is the most telling complaint of all. Here is where the absence of theory shows up in vivid colour. GAAP includes nothing explaining how adding decades old entry market measurements of some assets to current prices of others relates to what users want to know. As an investor, what can I do with information on the acquisition cost some years back of an intangible, or tangible, asset? And what does the book value of my shares based on the hotchpotch of accounting rules tell me? What am I to make of the inclusion of LIFO expense data in the income statement of one of the companies I am considering while another shows cost of goods sold according to the first-in, first-out cost flow assumption? *The rule book makes no attempt to show that there is any connection between its provisions and useful information.* And the members of our 'profession' show no signs of caring.

One reason the profession's rule book does not connect rules to useful information is that it has no place for useful information. It's not a question of a difference of opinion regarding what information is useful; it's a lack of interest in usefulness. What kind of a profession is it that shows no interest in accomplishing its objectives—or at least not enough interest to bother to tie its prescriptions to objectives? True, the standards setters have laid out objectives, but in the succeeding quarter-century they have not asked accountants to pay any attention. West notes that the decision-usefulness objective is not controversial; yet it is neither stated nor implied in the profession's rule book. Does that state of affairs mark any other profession? Do physicians practise medicine without trying to prevent and cure disease? Does the legal system, as opposed to certain greedy

practitioners, completely disregard the concept of justice? Again, we find ample reason for West's concern regarding the professional status of accounting.

Chapter 4 includes a section on conceptual frameworks and accounting rules. Here West is true to the Sydney tradition in his opposition to future-oriented definitions of elements of financial statements. (Readers may wish to peruse the special issue of this journal devoted to conceptual frameworks, October 2003.) Under the FASB's definition, 'all assets are reduced to abstractions; when assets are "future economic benefits" they are only ideas about the future' (p. 81). More generally, West argues against the board's conceptual framework as not capable of achieving its objective of providing 'the means by which the quality of accounting standards and related rules will be improved . . . [S]uch an outcome can only be achieved if the basic failing of present accounting rules—that they are not disciplined by a correspondence with "real-world" events and circumstances—is addressed' (p. 80). Even in a concepts statement (which is not a rule), the board failed to carry through, in its statement on recognition and measurement, with conceptual guidance regarding making measurement choices consistent with the decision-usefulness objective.

In sum, 'It is possible to have a "knowledge of accounting rules". However, this cannot be assumed to embody an accounting knowledge that yields a functional system of financial instrumentation' (p. 84). Knowing the rule book is not the same as knowing how to provide a professional service to the public. Applying the rule book does not assure service to the public.

One important bit of evidence regarding the profession's contentment with following the rule book may be found in the standard report of 'independent auditors'. The customary form in the United States says that the statements present fairly the company's financial position and results of its operations and its cash flows in accordance with American GAAP. This is generally taken to mean that that the statements are fair according to GAAP. That raises the question of how long the investing public will be satisfied with statements that get a passing grade only on the criterion of conformity with the rule book. Would you be content with a doctor whose only concern when serving you is that he does not violate a thousand page rule book? Would any respectable doctor be content to have followed the rule book while the patient died? In the context of the thousands of cases of investors losing their financial life because of accounting failures, will the survivors be willing to continue on the same basis?

The scope of West's subject does not include suggesting a proper auditor's report, conceptual framework, or measurement system, although he does add a brief synopsis of the Sydney view on measurement in his last chapter. Such matters are, however, clearly crucial to the development of a profession devoted to serving the interests of the investing public. I wonder how much more time will pass before the profession addresses these matters—and what will happen to it in the meantime.

After his scathing attack on the nature of accounting rules, West turns his attention to possible explanations for their existence in *Chapter 5, Explaining the Proliferation of Accounting Rules*. Why so many rules? One might argue that all of the activities of 'standards-setting bodies' in the past sixty-five years have been devoted to adding rules to the body of principles that were already generally

accepted. An interesting exercise would be to find or assemble a short statement of accounting principles generally accepted at the beginning of the organized effort to state accounting principles or standards—the late 1930s in the U.S.—then review that statement to see if any of those principles have been substantially changed or any distinctly new principles added since that date. If changes have been made, how much standards-setting effort would really have been required to make those changes? What have been the objective and results of all of the remainder of that effort?

One possible explanation for the regulation of accounting is market failure. In this view, the good is enterprise financial information; the suppliers are the reporting enterprises and the consumers are largely the investing public. The argument is that in a free competitive market, equilibrium is reached when the marginal cost of supplying the good equals the marginal utility of the good to consumers. However, in the case of enterprise financial information, the product is a public good. When a consumer uses it, the product is not consumed but is still there for other consumers to use. Therefore, no buyer captures the whole benefit and no producer gets paid for it. To each consumer, it is a free good, so there is no revenue to the supplier. Without a matching of cost and benefit, the marginal equality case does not apply. The market setting is inapplicable.

West addresses the agency literature dealing with managers recognizing the value of auditing and the possibility that some sort of mutually satisfactory arrangement could be worked out without regulation, but he does not buy it. He could have brought up more concerns such as managers' incentives to deceive when reporting on their own performance, a 'catch me if you can' attitude in too many cases, and the lag between deceptive reporting and getting caught, all in the context of the rapid turnover of CEOs. The contestants in this game are not evenly matched; those managements which are so inclined become masters of the art of skating close to the line, influencing their friendly auditors to adjust the line a smidgen, and lobbying the standards-setting establishment to avoid any serious adverse change in the line's location. So, as Sterling (1990) and Chambers (1993) appositely argued in this journal, the agency approach does not work. Perhaps an imaginative reader seeking a research topic relevant to the role of regulation will consider investigations of the effectiveness of financial reporting by relatively unregulated enterprises, including non-public businesses and not-for-profit organizations. Such work could, perhaps, shed some light on the idea of foregoing regulation of public companies.

The heart of Chapter 5 is a refutation of the argument that rules have been promulgated to address the failure of the free market to serve the public: If that were the explanation for making rules, those rules would have to address the failures by (a) clarifying how financial reporting could better serve the public and (b) making rules requiring such service. First, regulators would identify the erroneous and/or missing information, then make rules addressing those specific deficiencies. West does not see such a pattern in accounting regulation. Instead, accounting rules have been carefully designed to conform to the extant pattern. Those who have been close to standards-setting bodies are aware of the widespread use of

the 'reasoning-by-analogies' approach. How does GAAP deal with those phenomena most like the one in question? In West's words, 'accounting rules [have] remained subservient to the practices and subject matter of conventional accounting'. And conventional accounting has not sought to serve the investing public.

An alternative thrust of regulators concerned with failures of the market for financial information could start with efforts to identify aspects of the typical corporate governance system that provide perverse incentives—from the point of view of those seeking to serve the investing public. That could lead to explicit identification of the conflict of interests between corporate managers and investors with respect to financial reports that include evidence of management's performance. A logical follow-up would include serious efforts to combat smoothing of earnings and other techniques for suppressing evidence of risks and returns, thereby leading to rules that would better serve the public interest. It might also lead those regulators with the necessary power to act to recognize the conflict of interests between (a) auditors heavily influenced by managers and the accounting firm's total revenues controlled by those managers and (b) the investing public. That surely would suggest consideration of the corporate governance system provided for in the 1844 English Companies Act: Shareholders control both auditors and boards. More rapid rotation of audit firms could also reduce the auditor's fear of losing a client through disagreement on reporting issues because such a loss would involve less future revenue. But that emphasis on conflicts of interests has not been recognizable in the work of any regulator with whom I am acquainted.

Additional sections of Chapter 5 deal with the phenomenon of the accounting profession's control over the rule-making process. 'The concept of "accounting standards" as they are known today was devised and legitimated by the accounting profession' (p. 95). So far, so good! That control is consistent with the concept of a profession with 'elevated occupational authority'. We hope that physicians, dentists, and engineers maintain control over their standards—as long as they exhibit concern for the public interest. Ah, there's the rub! Where is the evidence that the accounting rule-making processes are tied directly to the public interest?

In this vein, West argues that the accounting profession looks at the making and application of rules as performing its duty:

The utility of accounting standards is thus represented as being innate: [quoting AASB 1028 (1994)] 'The establishment of an accounting standard . . . *will* assist users by providing relevant and reliable information' (emphasis added). Logically, the assertion needs to be of a different form: an accounting standard will assist users *if* its application results in the provision of relevant and reliable information. This, of course, then demands demonstration of how and why the prescriptions made will achieve this end. Instead, technical accounting rules are represented as having an a priori capacity to advance the serviceability of accounting information. That is, rule-making is presumed to have a functional role that is independent of the quality of the rules. (p. 103)

If that is true—that the profession is concerned with making and applying rules more than with serving the public—West's initial question regarding accounting's status as a profession is fully justified. Is there any other profession in which such a philosophy prevails? One might raise the question of whether doctors are being

pushed in that direction by the overzealous plaintiff's bar (in America) and the dysfunctional three-party arrangement under which the producer of the service is separated from the beneficiary by the intervention of a paying agent, to the detriment of the cost-benefit matching process. That arrangement—in medicine as in auditing—is a recipe for the frustration of everyone involved. To my knowledge, that does not happen in engineering; perhaps that is related to the public's acceptance of the technology produced by engineers.

Associated with the profession's control over the rule-making process is the tendency of the parties interested in that process to pay more attention to the legitimacy of the process than to the outcomes. Observers of accounting standards setting are fully aware that the most influential interested parties are corporate managements and their auditors. Indeed, since auditors have been observed typically to agree with their major clients' preferences, and since corporate managements have also proven their ability to call on governmental officials to support their insistent obstruction of proposals to change any basic rules or principles, the only special interest that exerts significant influence on the rule-making process is corporate managements. And that interest is seriously in conflict with the investing public with regard to information on its own performance. And it does have influence—more than is suggested by West's observation (p. 94).

West gives brief attention to the issue of economic consequences of accounting standards, noting that the profession has always taken credit for its importance to the capital allocation process in decentralized economies. He does not, however, go into the economic consequences argument in the FASB era in which special interests sought to avoid having their ox gored with no concern for the social value of financial reporting. Such resistance to the temptation to criticize those special interests is admirable; it is not necessary for, and might detract from, his more important message.

The remainder of Chapter 5 is devoted largely to concern for the lack of correspondence of the results of conventional accounting with observable commercial phenomena and circumstances. Much of West's discussion probably is agreeable to the typical accountant interested in theory; another part fits the thinking of the Sydney school better than it does that of the dominant wing of decision-usefulness theorists.

In my opinion, West could have given much more attention in this chapter to another explanation for so many recipes in the cookbook. It may be true that the investing public expresses a demand for clarification when a new financial phenomenon becomes popular—often aimed at skirting existing financial reporting rules. But that demand does not have the insistent character of the demand expressed by auditors. It is hard to overemphasize the strength of auditors' and preparers' need for clarification of how far they, working together, can go to achieve the demands of corporate managements which are strongly motivated to 'make the number' established in their own forecasts and those of analysts 'following' their company—the quarterly earnings per share number. This is the setting for demands for establishment of a 'bright line', up to which corporate financial managers can skate and auditors can approve without terrible consequences. The strength of those motivations makes the interests of investors like a gnat on an elephant in comparison. The conflicts

of interests that produce the motivations of preparers and auditors are not given sufficient explicit attention—even by West.

A great deal of lip service is given to the role of the independent auditor in the functioning of securities markets in the public interest. A socially acceptable but superficial amount of recognition of that concept appears in the pronouncements of accounting and finance organizations. In my opinion, nearly all auditors try to be independent and honestly believe they are independent. Few of us believe we are seriously biased. But the circumstances make it difficult. Typically, the engagement partner on an audit has grown up professionally associated with the client, as he or she has worked on that audit since year one in the profession. The auditor spends much time over the years with client personnel, at work and at play. Client personnel honestly believe they should be entitled to report what is really going on in the enterprise, as they understand it, and that understanding rubs off on the friendly auditors over lengthy exposure. Compare that understanding and friendship with the auditor's association with the faceless investors, and it is clear that the state of mind called independence would require a supreme effort by the well-meaning auditor. Add in the auditor's responsibility for selling the firm's non-audit services to the client and the serious personal losses (of audit and other revenues to the firm and personal standing in the firm) if a disagreement resulted in loss of the client and it is clear to independent observers, such as we marvelously objective academics, that an expectation of true independence, much less favouring the interests of the presumed beneficiaries of the professional service, as in other professions, places an unreasonable burden on auditors. We owe nothing less than our maximum admiration and respect to those who bear that burden without stumbling. We owe considerably less to the system of corporate governance that places such burdens on mere mortals.

ACCOUNTING RESEARCH, EDUCATION, AND PRACTICE

Chapter 6, Professionalism, Accounting Rules and Accounting Discourse, is concerned with accounting research. Its central theme, that there is a dearth of research of the type characteristic of professions, namely, contributing to knowledge that can improve practice, is a popular one, as indicated by twenty-seven quotations in that vein. Practitioners do not value academic accounting research; standards setters find little value in it; and teachers rarely use it in teaching students how to account. '[T]he thesis of the present chapter is that the accounting profession's contentment with present rules and its self-assigned task of interpreting and applying those rules has stymied the development of discourse oriented to seeking improvements in accounting practice' (p. 138).

In contrast, West finds that research in other professional fields is heavily oriented to finding knowledge that can be applied in practice. It surely is not necessary to give many examples of that orientation in engineering, dentistry, medicine, or law.

For a profession's scholarly discourse to be disconnected from its practice would be anomalous and disabling. It would condemn either the significance of research findings (for the lack of utility of the knowledge produced), or professional practice (for not being

based on knowledge or being unresponsive to the new knowledge emerging from scholarly discourse). Or it would condemn both. (p. 117)

Is accounting research on death row?

One issue that arises in thinking about the nature of accounting research is how it might reasonably compare with research in scientific fields. Consider other professions. Medicine is a professional field resting substantially on biological sciences such as vertebrate zoology, physiology and cellular biology. The basic science on which engineering rests is physics, with perhaps some support from chemistry and meteorology, and others. It may be more difficult for a layman to identify the fields that underlie the practice of law—perhaps political science, logic, and philosophy. One thing seems clear: No profession can be viewed as a science itself—neither a natural science nor a social science. On the other hand, research in underlying sciences can be enormously helpful in developing new protocols for treatment of patients, or new materials for structures. West argues that research in a professional field, as opposed to research in a natural or social science, contributes to the body of knowledge useful to practitioners in *prescribing* human behaviour. A professional service provides guidance to its intended beneficiaries, based on the professional's expertise, which is derived from experience and acquaintance with a body of professional knowledge. Professional research aims at enhancing that body of knowledge. Scientific research on issues that are known to, or might, bear on the practice of the profession could be of value to professionals. In addition, research bearing on the application of scientific knowledge in developing protocols for the treatment of patients, for example, is aimed more directly at prescriptions.

West feels that 'a research programme that yields no prescriptions' (p. 127) is of little value to the practice of a profession. An example might be research among a population of obstetricians aimed at finding typical answers to the issue of vaginal or caesarean delivery given a set of measurements, etc. Knowing that answers in practice are often influenced by the fees doctors receive, a professor of obstetrics might not use the results of such descriptive research in teaching students how to make such a choice. Similarly, descriptions of financial reporting choices made in practice, as reported in a professional publication, or descriptions of managers' financial reporting choices under the influence of earnings-based bonuses, might not be found useful in teaching accounting—or in the practice of accounting by a professional devoted to the welfare of readers of financial reports. Thus, West finds that prescription is the essence of professionalism; descriptive research in underlying sciences (which is not professional research) can be helpful if it is useful in formulating prescriptions.

What sciences underlie accounting? Under a broad definition of managerial accounting, including the managerial control function as part of accounting, psychology has often been thought to have something to contribute. Perhaps it does in understanding the behaviour of investors and of accountants acting in various capacities as well. The basic social science underlying accounting, however, is economics. The particular subfield of economics that is most relevant is called financial economics; the broader area is microeconomics. In suggesting this, I am departing from West's interests. He mentions economics very little and I do not recall finding

'financial economics' in his book. To me, investors are by far the dominant users of published corporate financial reports, and they operate in the world of financial economics, or finance, for short. Therefore, research in the science of financial economics has a reasonable chance of being helpful to accountants interested in serving the investing public. Rather than pursue this line of thought further, I suggest that accounting professionals desiring to serve investors might well seek knowledge of possible connections between (a) observable economic phenomena and circumstances involving the reporting enterprise and (b) financial markets. I also suggest that the state of those professionals' knowledge in that area at present is abysmal.

West's contempt for much of the descriptive research that has been published in recent decades is palpable. He mentions research showing that managers prefer accounting methods that make them look good and maximize their earnings-based bonuses, but seems underwhelmed by the value of such surprising news. (He does not mention that the most acclaimed accounting research of the twentieth century showed that investors are influenced by the earnings reported by public companies.) I get the impression that he does not see how such research contributes to the practice or teaching of accounting. The dearth of research in the heart of accounting—the measurement and reporting of enterprise wealth and income for informing investors—is the worst-kept secret in the accounting world. But few academics have faced up to what has happened: accounting research has been hijacked by methods specialists who teach their prized research methods to aspiring academics, and those teachers and students of research methods constitute the only significant market for such incestuous research—which, incidentally, enjoys the financial support of the public.

West faces up to the discouraging views of those who have no hope of finding genuine professional accounting knowledge. One rationale for such discouragement is 'that it is not possible to describe the financial features of firms in an objective and systematic manner because such features do not possess an independent and discoverable reality' (p. 133). The incompatibility of that view and the Sydney view of accounting measurement is obvious, as is West's opposition to it. Financial economists who live and die by the sword of observable market prices presumably would find it equally offensive. Secondly, he mentions the view that it is impossible to get agreement on a set of standards without considering the preferences of several parties who are never going to agree. If 'the ideal of accounting practice is universal acceptance', this is a problem. It seems to have little to say, though, about how to improve accounting practice in the interest of the recipients of one particular class of accounting reports—published external reports. Finally, he identifies and rejects the view that the establishment of accounting standards should be a sufficiently democratic process to give weight to the preferences of all special interest groups. Is this comparable to giving weight to the views of thieves in defining 'felony' or to those of cigarette manufacturers in setting standards for identifying lung cancer? Or, less pejoratively, giving equal weight to people who are not investors—for example, preparers, auditors, or teachers—in establishing standards for financial reporting to investors. Again, the whole world need not be accorded votes in deciding what information to report to investors when it is paid

for by investors. I hope vegetarians are not given equal voice in determining standards of hygiene in slaughterhouses. Or, as West asks, 'would anybody accept that medical practices should be determined by plebiscite?' (p. 136). Note the contrast with the broad public interest in income tax laws.

Referring to the question of whether there can be a theory-based, prescriptive body of accounting knowledge, West acknowledges that the generally accepted literature of accounting cannot be used as evidence for the affirmative case. But he reminds us that the key to the accounting profession's status—elevated occupational authority—implies that such a body of knowledge exists; if it does not, that authority would seem precarious. A specific part of that authoritative status is the place of accounting studies and research in university curricula and professors' research. 'It is incumbent upon those who deny the possibility of professional accounting knowledge to offer some alternative justification for the position they occupy within the university system' (pp. 137–38).

West turns to *Accounting Education* in Chapter 7 with criticisms and suggestions consistent with the general theme of the book. Readers will not be surprised that he is dissatisfied with the emphasis on rules found in the teaching of accounting. 'The ideals of professional education, therefore, must extend beyond the development of technical proficiency to emphasize the acquisition of knowledge. This requires that what is taught be supported by logical argument or other persuasive evidence' (p. 141). As an example, a technician who is not a professional, such as a dental assistant, may learn and apply rules for performing many tasks in a dental office, but only a professional is prepared to choose between a restorative procedure and extraction. West wants accounting students to be prepared for more than following rules; they should be prepared to make contributions to the advancement of the profession's service, able to see a larger picture than a rules-based focus reveals. He presents fourteen quotations expressing similar concerns. At bottom, he feels that 'the most fundamental problem with accounting education is accounting' (p. 154). He might have added that a rules-focused curriculum does not attract professional level students, a concern that is shared by a great many recruiters and academics.

Inevitably, an educational experience anchored to these rules cannot escape their limitations. More particularly, the pedagogic impact of present accounting rules has been to fragment accounting curricula, establish barriers to comprehending the nature of the commercial environment, mandate the teaching of accounting practices that cannot be substantiated by argument or evidence, and foster superficiality in both learning and teaching. (p. 154)

He explains each of those four charges in subsequent pages.

One specific point regarding the typical approach to accounting education, which I would apply to cost accounting as well as to financial accounting, is that 'Accounting rules contain prescriptions pertaining to particular accounting "inputs". They do not deal with the aggregative "outputs"—financial statements—that are the "finished products" of accounting' (p. 154). Who else would teach students how to make a product by starting with materials and operations before gaining a clear conception of the product at which all of the effort is aimed? Is

an architecture student learning to put some bricks, mortar, pipes, and wires together, or is he/she learning to create lighted, comfortable, healthy space in which a family can eat, sleep, study, and relax? In accounting, 'achieving compliance with individual rules is customarily treated as a terminal outcome' (p. 155).

This leads us to the absence of theory. One of the strangest phenomena in accounting education is the apparent comfort academics enjoy in teaching accounting without theory. In my understanding of evolution, organisms develop features that assist them in adapting to their environment—or they do not live there. What explains the willingness of accounting teachers to continue struggling through the accounting rule book without devising a theoretical structure to bring some order to the mass of inconsistent rules? Where is a theory of GAAP? In my opinion, accounting teachers don't really think they are teaching a professional field. One probable outcome of efforts to state a theory of GAAP would be disclosure of the inconsistencies and sterility of purpose there. On the other hand, teachers in a service-oriented professional field might try to build a theory that starts with service to the public—in our case the investing public. Such a theory could be called 'decision-usefulness theory', in recognition of its objective: to provide financial information useful in making decisions. After decades of widespread acceptance of that objective by service-oriented accountants, I have not seen a financial accounting textbook designed for use in teaching decision-useful accounting. Unfortunately, I cannot blame practically minded authors for not investing in such a risky venture.

West points out the popular alternative to teaching with the assistance of a theory. 'Unable to locate with confidence any patterns or consistent principles in the accounting standards they are required to master, accounting students are forced to adopt the most mundane of learning methods: rote processes' (p. 155). What a handicap for students to bear! And for what gain? An alternative approach would be to start with the setting in which external financial reports are used and the decision-usefulness objective, then approach each line item topic by discussing how best to achieve the objective in the easiest case, then gradually load on the complicating circumstances and the adaptations that accountants make to cope with those circumstances in practice—perhaps even including the preferences and power of managements. This leads to GAAP in many but not all cases, and to the differences between financial reporting to serve investors and financial reporting to serve special interests.

In the penultimate section of the chapter, West points out that academics have given at least lip service to definitions of accounting and statements of accounting objectives that include matters such as measuring, and communicating economic information to permit informed decision making. He wonders why academics are not willing to lay a base for the study of accounting using the foundational materials of those subjects. 'The purpose of accounting is said to subsist in aiding decision making, but the nature and structure of decision-making processes are not investigated. Accounting information is said to be communicated to interested parties, but the principles of effective communication are left unexamined' (p. 161). As I have mentioned above, the base subjects that I emphasize are economics in general and financial economics in particular, because investors' decisions are

precisely the subject matter of financial economics. That would include matters such as complete and perfect markets, market imperfections, observable market prices, and the generally accepted cash flow approach to financial decisions. But that is a subject for another paper. The point is that the body of knowledge that is the heart of a profession's specialized expertise should be built on some defensible base. Consideration of the basic disciplines on which other professions are based and reviews of their curricula might be worthwhile.

Surely there is no more important task facing accounting in general and academics in particular than development of the components of an accounting theory on which we can achieve substantial agreement. That would enable us to 'provide students not just with a knowledge of current practice, but with the knowledge to evaluate critically that practice and seek its reform' (p. 162).

Professionalism, Accounting Rules and Accounting Practice—Chapter 8—incorporates West's views of the impact that the rules-oriented approach to accounting guidance has had on the daily work and on the standard of public service provided by accounting. He sees practice as the application of professional knowledge in the service of members of the public. The heart of the matter is the relationships between authority, responsibility and independence. Accountants have been granted the authority to perform certain services, but do they take commensurate responsibility and do they have sufficient independence? Without independence to perform their work in accordance with their best judgment, people are likely to excuse themselves from responsibility. 'It's not my idea, but that's what the rules say.' Whenever 'Regulatory fiat rather than cognition is what impels the actions of practitioners' (p. 174), professional independence suffers. Responsibility follows from authority and independence. Furthermore, one could argue that the greater the dependence on rules, the less the 'professional' is likely to use his or her own judgment, which sounds to me like a recipe for disaster. In West's words: 'Directives that, without robust justification, compel practitioners to apply certain procedures, or require the making of precise judgements about matters upon which insufficient evidence is available, are antonymic to professionalism. The grounds for enforcing the ideal of professional responsibility wane whenever practitioner autonomy is surrendered to extraneous influences' (p. 168).

One is reminded of the conflict between physicians and administrators of health insurance plans or government health plans. The more rules that are forced upon the professional, the less professional her work. Also, rules that are inconsistent with serving the investing public can lead accountants in general, especially students, as discussed in West's preceding chapter, to view GAAP as a 'black box' that is not to be explained, only memorized.

How could auditors have allowed this to happen? Unfortunately, human frailties do not skip the accounting fraternity. Between the pressure from their friends in management, the threat of malpractice liability, and a natural willingness, if not desire, to have someone else to blame, it is not surprising that auditors can be talked into taking 'flight from responsibility' (p. 171) and seeking refuge in a morass of rules that they are quite willing to apply. I suspect that for most of us, that beats baring our chests as heroes. It's not auditors' fault.

A reader may be surprised that West does not draw a bead on the independence issue that bothers so many observers: pressure from management to assist in reporting favourably on management's stewardship by playing the standards avoidance game. The reason for that omission must be that it does not fall under his subject: professionalism and accounting rules. Similarly, two practices that have been viewed as at the edge of professionalism—competitive bidding for work and advertising—are addressed briefly, with no strong conclusion. In the context of West's work, it is apparent that behaviour that suggests too much emphasis on maximization of profit as compared with serving the needs of the public, whether the client is able to pay or not, raises a question about professionalism in any field. The large accounting firms may be able to point to their pro bono work as similar to that of lawyers and doctors, but a modicum of charity is not as clear evidence of professionalism as is serving clients' needs day in and day out and taking responsibility for the quality of one's work. But the importance of these issues does not follow from an excess of accounting rules, so they are beyond West's scope.

Later in the chapter, West directs his fire on the standard auditor's certificate. The wording of the opinion avoids any reference to responsibility for substance, instead settling on attention to compliance with rules. 'Rather than testify to the presence or absence in financial reports of the significant and general qualities necessary to ensure that those reports can be relied upon to serve their widely attributed functions, it is proposed to offer only an opinion indicating whether prescribed rules have been complied with' (p. 170). More words are devoted to warning the reader of what an audit is not than to attesting to any inherent qualities in the financial statements. Each of the financial statements is named, but no indication of information content is included. In defence of auditors, I must say that, especially in the litigious environment of my country, if I were an auditor I would be afraid to guarantee the essence of financial statement information without a very strong set of caveats. At best—even under the wonderful set of standards that I might favour—the danger of investors reading too much into the statements would loom large in my mind. But West's criticism is valid.

A final target in West's sights is the professional (non-academic) literature of accounting. The content of professional journals has more of the character of a general business magazine than it does a technical journal. The only bow to professional accounting concerns is a reprinting of new rules. In my own experience as a young academic (in the 1950s), the premier American publication—*Journal of Accountancy*—included articles on technical issues. Now, such articles seem to appear only when an FASB staff member is assigned to provide some understanding of the board's views on an issue currently under deliberation or recently resolved. Both the supply and demand for such subject matter is missing in an environment in which rules are the only things that matter. Further back, in the early years of the twentieth century, before the rule book was invented, substantive technical arguments raged in that journal, even if they tended to resist resolution in the absence of guidance from a theory. West reports a similar trend away from professional interests in Australian journals.

The chapter's concluding section reiterates some of the author's key points.

[T]his rule-book form of accounting has not...served to enhance the professional authority of accounting practitioners. Professional authority is a cognitive authority, not the authority of regulatory fiat...

[T]he three essential ideals of professional practice—authority, independence and responsibility—have been severely disabled within the professional accounting context. Remediation of this situation is not to be found in the issue of more technical rules of the kind that have contributed significantly to the present discomposure. Instead, the invigoration of professional accounting practice must proceed from advancement in professional accounting knowledge: a specification of the bounds and principles of accounting practice which provides a cognitive authority that accounting practitioners can independently administer and be accountable for (pp. 178–79).

PARTING COMMENTS

Advancing Professional Accounting Knowledge, Chapter 9, is an answer to all of those readers who might have been thinking through the previous eight chapters that West enjoys destruction more than construction. Here he lays out the type of cognitive basis for accounting that he would like to see adopted. As suggested earlier, it is substantially the well-known Sydney view—meaning that argued for decades by Ray Chambers and associates. One could complain that it lacks originality, but in my judgment he owes it to newcomers to the literature, including young folks and those who have been on Mars, to make some positive prescription. I sincerely hope that the unorthodox Sydney view of asset and liability measurement does not repel readers who are not members of that club; the essence of West's message does not depend at all on acceptance of that view. Indeed, even most of Chapter 9 fits other views of measurement as long as they can be defended within the context of decision-usefulness theory. I suspect, however, that those not previously convinced might not feel that West has accomplished what I consider a secondary objective: demonstrating 'that present accounting rules do not yield serviceable financial information' (p. 8). Fortunately, the message of the book does not depend on achieving that objective. Nor is the Sydney view critical to it.

In defense of West's right, if not obligation, to present his personal preference among accounting theories, I should say that if I had all of his abilities and the energy to undertake the prodigious effort necessary to produce such a book, I think I would have felt compelled to present my views on measurement.

A paragraph from the final chapter summarizes the more important ideas in *Professionalism and Accounting Rules*:

In the absence of a coherent and rigorous theoretical framework, the specification of individual rules for each and every kind of financial instrument and transaction, whether in statute, professional standards or other regulatory dicta, is to little avail. This is so for a variety of reasons. First, the dynamic and complex nature of the commercial environment suggests that such rule-making will constantly be in deficit as it lags behind the continued evolution of business practices. Second, this deficit is likely to be accentuated by the willingness of participants in commercial activity to structure transactions with the intention of circumventing the rules or taking advantage of their

flexibility. Third, a 'rule-book' style of accounting is likely to foster a tendency to interpret what has not been precisely proscribed as having been condoned. Fourth, and being the cumulation of the foregoing factors, a constant expansion and amendment of technical rules is likely to result in higher compliance costs but greater risk that non-compliance will pass undetected. These scenarios are already evident in contemporary accounting practice which is increasingly characterized by a 'rule-book' style of regulation. (p. 191)

On this ending, I rest my case. Brian West has made a masterful analysis of a problem of great importance to the accounting profession. We should all feel indebted to him. I regret that Ray Chambers did not live to see the completion of West's work and how it is being received.

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Gaps in Guidelines on Audit Committees

Since the 1940s, advocacy of the establishment of audit committees was undertaken by regulatory agencies, and subsequently by the accounting profession, and committees representing combinations of interest groups. Over time, this advocacy literature has reflected changing views about the key responsibilities of audit committees. Initially, audit committees were primarily concerned with negotiations with (or responding to) auditors, and reviewing financial statements prior to publication. Since the 1970s, formal guidelines or requirements have suggested additional responsibilities that involve oversight of the internal management of corporations. There is a pattern of renewed enthusiasm for enhanced corporate governance and for a stronger role for audit committees following spates of corporate crashes or disasters. Nevertheless, some of the lessons from those events continue to be ignored, so that arguably there are gaps in contemporary guidelines on audit committees. These gaps concern the need for audit committees to review the structure and design of delegations, and the adequacy of financial and operational information being provided to senior management and boards (particularly concerning subsidiaries and associated entities). These gaps are also reflected in the charters of the audit committees of Australia's top 200 listed entities. However, in some respects, Australian practice has gone beyond the recommendations embodied in recent guidelines. Drawing from literature and practice, this article proposes a model charter which, if adopted, may contribute to improvements in the effectiveness of audit committees.

Key words: Accountability; Audit committees; Governance; Model charter.

Since the 1970s, a range of regulatory bodies or interest groups have actively promoted the idea that the establishment of audit committees would improve financial reporting, or strengthen corporate governance.

Advocacy of audit committees within major corporations has intensified after successive spates of corporate failures in successive decades since the 1970s. Canada has required all federally incorporated corporations to have audit committees since the 1970s. The New York Stock Exchange, in the aftermath of a series of major failures, required listed entities to have audit committees in 1978. Recent high-profile corporate disasters such as Enron and WorldCom have led to U.S. legislation making audit committees compulsory for all SEC-registered entities. Since July 1996, the Australian Stock Exchange has required listed entities to

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disclose if they have audit committees—and if not, explain why not. In March 2003 that stance was strengthened by listing rules requiring major listed companies (those on the S&P/ASX All Ordinaries Index) to have audit committees.

The establishment of audit committees, it has been claimed, represents ‘best practice’ in corporate governance. With all this apparent enthusiasm for the establishment of audit committees, it may seem churlish to record a few points.

First, the label ‘*audit committee*’ is misleading. These committees don’t do any ‘auditing’. They may spend some time talking to auditors, and audit committees may even be formally assigned the responsibility of selecting and engaging the external auditor (as in the U.S.A.’s Sarbanes-Oxley Act). But audit committees do not audit in their own right. Nor are they responsible for the audit opinions on financial statements.

Second, audit committees are unlikely to contribute to improvement in the quality of the external audit function. At best, audit committees can focus external auditors’ attention on what members believe are issues of concern (and play a role in securing value from the audit process). As a former president of the Institute of Chartered Accountants of Scotland once observed, ‘only auditors can improve the quality of auditing’ (Flint, 1980). Arguably, auditing cannot be entirely improved without changes in the accounting framework that would ensure that information presented in financial statements is capable of independent corroboration (see Chambers, 1973, pp. 148–9; Wolnizer, 1995).

Third, the performance of audit committees necessarily depends on the people involved, their knowledge, skills, critical capacities, scepticism and determination. The 1970s contention that audit committees might avert distorted financial reporting now seems dubious. So too have the 1980s and 1990s contentions that audit committees reinforce the independence of both auditors and external directors. Recently failed Australian companies, such as One.Tel, HHH Insurance and Harris Scarfe, all had audit committees, and nominally ‘independent’ directors. On the face of it, none of those committees ensured that audited financial reports, signed with the approval of those directors, were not misleading.

Nevertheless, it is now widely accepted that the establishment of audit committees can enhance corporate governance—if only because they provide a forum for concentrated attention to be devoted to issues which might challenge the attention span of directors who are not, to use a cumbersome phrase, ‘financially literate’. Further, because the corporation’s financial data concern the performance of executive directors (‘management’), ‘it is important to have a forum for discussing this data, in which management participates only on request’ (American Law Institute, 1994, Vol. 1, p. 105).

However, over the years much more attention appears to have been devoted to advocating the establishment of audit committees than to analysing what they should do. In recent years there have been significant changes in expectations about what audit committees can contribute. Initially they were seen as subcommittees of boards that were to meet with and deal with matters raised by the auditors. Contemporary expectations seem to be that such committees will also be responsible for overseeing many aspects of the management of a corporation.

AUDIT COMMITTEE CHARTER

This article sets out to review the audit committee advocacy literature, and to chart changes in ideas over the last three decades. Recent studies have found that audit committees do not always perform all of the functions assigned to them in their formal 'charters' (see, e.g., De Zoort, 1997). Even more alarming may be the argument advanced here: that some basic responsibilities that could be assumed by audit committees continue to be overlooked in formal guidelines—and hence, in the practices of audit committees of major corporations.

Undoubtedly different parties will hold different views about what is the appropriate scope of the responsibilities of audit committees—often reflecting occupational perspectives. Internal auditors want to enhance their influence by talking to company directors as well as senior managers. Partners of audit firms want audit committees to spend time talking to them. This may reflect external auditors' wish that directors will assume responsibility for decisions about accounting treatments, and for addressing identified weaknesses in internal controls—thus reducing the auditors' litigation risk. Possibly auditors once saw the opportunity to talk directly to external directors as a means of cross-selling non-audit services. Investors, for their part, may well expect boards and their subcommittees to be proactive in growing shareholder value, while safeguarding human, physical and financial resources. Directors may be wary of the introduction of rules or guidelines that may expose them to claims of negligence.

The approach adopted here is to review recent guidelines or other authoritative statements about the role of audit committees—and then to summarize matters about which there seems to be a consensus, and identify other responsibilities that are considered appropriate for contemporary audit committees. Second, this article compares expectations about what audit committees should do with the practices adopted by major Australian listed entities. Finally, the opportunity is taken to suggest a model charter for an audit committee. That charter may reflect contemporary expectations about what such a board subcommittee does in order to make an effective contribution to the governance of major organizations.

HISTORICAL BACKGROUND

There is some evidence of British and U.S. companies establishing a committee of directors to oversight the activities of auditors in the nineteenth century (see Mautz and Neumann, 1977, p. 1; Tricker, 1978, p. 56). In 1940, in the aftermath of major frauds within McKesson & Robbins, Inc., the New York Stock Exchange (NYSE) suggested that auditors should be selected by a committee of external directors rather than by management (CICA, 1981). The Securities and Exchange Commission (SEC) proposed that the appointment of auditors should be approved by stockholders, and that 'Establishment of a committee to be selected from nonofficer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement' (SEC, 1940). After further criticisms of misleading financial reporting (notably the BarChris case), the American Institute of Certified Public Accountants (AICPA) recommended that all publicly owned

corporations appoint committees of outside directors to nominate independent auditors 'and to discuss the auditor's work with them' (AICPA, 1967).

However, it appears that it was not until the 1970s that support for the establishment of audit committees gained strong momentum in North America (see, e.g., CICA, 1981; Birkett, 1986). Arguably, the greatest impetus for the establishment of audit committees came from regulatory requirements. Canada, in the aftermath of the 1965 collapse of Atlantic Acceptance Corporation, led the way with five provincial statutes dating from 1970 that required corporations offering securities to the public to have audit committees of not fewer than three directors, with a majority 'external'. Similar amendments to Canada's federal Business Corporations Act, effective in 1975, required all federally incorporated public companies to have an audit committee whose duty was to approve the annual financial statements before they were submitted to the board (see CICA, 1981, Appendixes A and B).

In 1972 the SEC endorsed the establishment by all publicly held companies of audit committees composed of outside directors, and urged the business and financial communities and shareholders 'to lend their full and continuing support to the effective implementation of these recommendations' (SEC Accounting Series Release 123). Subsequently the SEC required disclosure of 'the existence and composition of the audit committee of the Board of Directors' (SEC Accounting Series Release 165, 1974).

After later scandals surrounding the adequacy of financial disclosures by major corporations (notably Lockheed and Penn Central), the U.S. Congress enacted the Foreign Corrupt Practices Act (1977) that included requirements for companies to document extensively their internal financial controls—a requirement leading to 'further expansion of the audit committee agenda' (Vanasco, 1994, p. 21). Also in 1977 the NYSE issued a policy statement foreshadowing that all listed entities would be required to establish audit committees composed of independent directors by 30 June 1978. Soon afterwards the Securities and Exchange Commission 'proposed stringent rules for three standing corporate committees—Nominating Committee, Compensation Committee and Audit Committee' (Vanasco, 1994, p. 20).

These U.S. initiatives prompted the (then) Big 8 accounting firms to actively promote the establishment of audit committees. Accounting firms on both sides of the Atlantic began publishing guidelines on how to establish and operate these committees (several of which were cited by Tricker, 1978).

Further corporate scandals brought forth further proposals for enhancing the powers and extending the responsibilities of audit committees. In October 1987, the final report of the National Commission on Fraudulent Financial Reporting (Treadway Commission), a body established by a coalition of professional associations,¹ recommended that audit committees be established with written charters, composed solely of independent directors. The focus of this report was on the 'risk of fraudulent financial reporting practices', and one of the commission's proposals

¹ The AICPA, American Accounting Association, the Institute of Internal Auditors, the Financial Executives Institute and the Institute of Management Accountants (then known as the National Association of Accountants).

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was that audit committees be advised when management sought a second opinion on a significant accounting issue.

However, with a few exceptions (such as Singapore, Malaysia and Israel), countries outside North America have not followed the path of compelling listed companies to establish audit committees.

In Australia, a Senate Standing Committee on Legal and Constitutional Affairs (the Cooney Committee) recommended mandatory audit committees for listed companies in 1989, but the government responded (two years later) by announcing that it proposed to monitor the development of audit committees 'before giving consideration to a legislative approach'. Around the same time, in November 1991 a House of Representatives Standing Committee on Legal and Constitutional Affairs (the Lavarch Committee) recommended that requirements for listed companies to establish audit committees be incorporated in ASX Listing Rules. The ASX preferred to adopt a less stringent approach—and eventually only required listed entities to describe the corporate governance arrangements they had in place (ASX Listing Rule 4.10.3), and in particular state whether audit committees had been established—and if not, explain why not (ASX Listing Rule 4.10.2).

The rationale for such an approach was generally expressed as a recognition that the circumstances of companies differ, and that in some cases boards might prefer to exercise certain responsibilities themselves rather than delegate those tasks to subcommittees. It has been suggested that the ASX has taken the view that it was inappropriate to regulate the internal functioning or structure of listed companies (Stapledon and Taylor, 1998).

In the absence of statutory requirements in Australia and in the U.K., coalitions of interest groups and professional associations and review committees have issued 'best practice' guidelines on aspects of corporate governance—and much attention has been given to the formation and operation of audit committees.

One of the earliest of these was issued in 1990 by a committee² chaired by the retiring chairman of Australia's NCSC. A thirty-page discussion paper, *Corporate Practices and Conduct* (Bosch Committee, 1990), responded to concerns about a series of corporate crashes that had occurred in the wake of the stock market collapse of October 1987. The committee advocated the establishment of audit committees in the following terms:

Many companies have, as a matter of course, set up audit committees to provide an effective mechanism for non-executive directors to be appraised of issues concerning the company's operations other than in the environment of formal board meetings. Audit committees provide an opportunity for non-executive directors (or the full board—if considered desirable) to achieve a full understanding of the role of the auditor in relation to an entity's directors, and its senior management.

As a minimum, all publicly listed companies should be required to have an audit committee.

² The 1990 Bosch Committee was comprised of representatives of the Australian Stock Exchange, Australian Institute of Company Directors, the Business Council of Australia and the Institute of Chartered Accountants in Australia, and the National Companies and Securities Commission.

Note the narrow objective of enabling directors to develop an 'understanding of the role of the auditor'.

The accounting profession was the target of criticism when companies had failed soon after published financial statements showing an apparently sound financial position. This was not a new experience in Australia. In the 1960s representatives of the accounting profession had deflected criticisms of accounting practices on to government for the inadequacy of regulatory arrangements, and for a failure to provide legal backing to accounting standards. The profession expressed dissatisfaction with the Companies Act, which needed 'strengthening'. It was claimed that the profession's accounting rules deserved legal backing. Practitioners complained that dissident auditors could be easily replaced. They defended the failure of auditors to be outspoken by explaining that an audit report could only be made on annual accounts, that auditors had no right to attend shareholders' meetings, and if they did speak out they risked being sued for defamation (Birkett and Walker, 1971).

Virtually all of these complaints were duly addressed by amendments to companies legislation. Accounting standards became legally enforceable regulations. Auditors of companies were afforded qualified privilege, protecting them against claims of defamation. Auditors were also given the right to report breaches of corporation laws to regulatory authorities without waiting for the preparation of an annual report. They were also empowered to attend company annual general meetings, answer questions and, in the event of efforts to remove them, to put their case to shareholders at the expense of the corporation (Walker, 1993). Yet, despite these reforms, a series of corporate collapses in the early 1990s—occurring soon after the publication of auditing financial reports which indicated that the companies concerned were profitable and had a sound financial position—meant that the auditing profession again found it necessary to defend its reputation. This time, new explanations were forthcoming. It was claimed that the reporting process had been unduly influenced by dominant CEOs, and that there was a need to ensure that auditors had the opportunity to discuss issues directly with directors. It was also suggested that audit tenders were at times an excuse to dispose of difficult auditors—and that one remedy might be to make audit committees responsible for handling such appointments and making recommendations to shareholders.

The 1991 Bosch Committee's faith in the power of audit committees to avoid problems with inadequate accounting and auditing seems touchingly innocent—not only in retrospect.³ However, the Bosch Committee's proposals were popular with the accounting profession. The Australian Accounting Research Foundation, in collaboration with representations of organizations representing company

³ The Bosch Committee report appeared shortly after the delayed publication of an inspectors' report on the 1983 failure of TEA Ltd. The latter outlined how TEA's audit committee had extensive discussions with auditors about complex transactions which generated 'paper profits' from property development projects, but had apparently accepted these treatments and had not communicated any concerns to the full board of TEA. On the face of it, the introduction of a board subcommittee would not necessarily enhance corporate governance unless members of those committees were diligent, had appropriate skills, and asked salient questions.

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directors and internal auditors, used the Bosch Committee as the base for a subsequent set of guidelines (AARF *et al.*, 1997).

In the U.S.A., the American Law Institute's 1994 contribution to the debate about audit committees was only part of a wide-ranging and scholarly analysis of potential reforms to corporation laws and governance arrangements. Arguably the American Law Institute's long-running corporate governance project—partial drafts were published from 1982—has had a major influence on corporations laws, and many elements of Australia's Corporate Law Economic Reform Program (CLERP) of the late 1990s can be traced to the American Law Institute's proposals.

One of the most influential sets of guidelines was issued in the U.K. by the Cadbury Committee in 1992.⁴ The Cadbury Committee report echoed but watered down many of the American Law Institute's draft proposals about governance arrangements, in an environment in which corporations were commonly led by executive chairman and boards of executive directors. The report may have startled English observers with its suggestion that the majority of members of listed public companies should be non-executive (and a decade later, that goal was still far from being achieved). The Cadbury Report was prepared soon after a series of scandals in the late 1980s and early 1990s (notably those involving the Maxwell group, BCCI and Polly Peck), which had led to the perception that auditors had become 'too close to the senior executive management, and had consequently, found it difficult to "stand up to" management when reporting on "difficult" features in companies' accounts' (Smerdon, 1998, p. 128). It was not surprising that the committee advocated that audit committees be compulsory for listed entities, though the rationale for this recommendation was framed more diplomatically:

A separate audit committee enables a board to delegate to a subcommittee a thorough and detailed review of audit matters, it enables the non-executive directors to contribute an independent judgment and play a positive role in an area for which they are particularly fitted, and it offers the auditors a direct link with the non-executive directors. (Cadbury, 1992, para. 4.36)

The Cadbury report emphasised two main roles for audit committees: negotiating with auditors and reviewing financial statements before publication.

While the business community may not have embraced the Cadbury recommendations with enthusiasm, a later Hampel Committee report (1998),⁵ commissioned by the U.K. Financial Reporting Council, did little more than reaffirm the sentiments of the Cadbury Committee without committing itself to strong conclusions about the general applicability of specific proposals. However, the Hampel Committee

⁴ Members of the Cadbury Committee were representatives of the Institute of Chartered Accountants of Scotland, London Stock Exchange, Institute of Directors, Institutional Shareholders' Committee, and one academic, Andrew Likierman.

⁵ The Hampel Committee included representatives of accounting, legal and actuarial firms, a finance director, the general manager (investments) of an institutional investor, and the chairs or CEOs of corporations.

produced a 'Combined Code', and the London Stock Exchange duly required listed companies to report on how they applied the principles in that code.

Similar exercises to Cadbury—the establishment of selected stakeholders to produce recommendation in governance issues—have followed, at regular intervals, in Australia, the U.K. and the U.S.A. Sets of guidelines have also been issued by bodies representing or advising fund managers or institutional investors (see, e.g., NAPF, 2000; AUTIF, 2001; Council of Institutional Investors, 2002; IFSA, 2002), and these have provided varying degree of support for the establishment of audit committees.

The OECD issued an influential statement of governance 'principles' to assist member countries in evaluating the institutional and regulatory framework for corporate governance (OECD, 1999), which included passing reference to the use of audit committees in supporting the audit of financial statements (p. 17). In turn, major institutional investors and others have lent their support to interpretations of the OECD principles, including advocacy of audit committees comprised of non-executive directors (see, e.g., Hermes, 1999; ICGN, 1999).

A theme common to these reports or guidelines was that the establishment of audit committees was a 'good thing' to do. However, as will be shown below, the involvement of representative committees in the process of developing best practice guidelines seems to mean that participants were able to promote their own perspectives about the role of these subcommittees of boards—leading to the publication of lengthening lists of proposed responsibilities for audit committees, more detailed proposals about audit committee procedures—and, overall, claims that audit committees *should have a more active involvement in governing or overseeing the internal affairs of corporations*.

CHANGING IDEAS ABOUT THE ROLE OF AUDIT COMMITTEES

As noted above, initial advocacy of audit committees came from the accounting profession. Major firms saw audit committees as a forum for communication with directors (and thus avoiding confrontation with dominant CEOs who also influenced the setting of audit fees).

The accounting profession actively promoted the view that a key role of such a committee is to provide auditors with a line of communication with directors of major corporations. Tricker (1978) saw audit committees as 'a mechanism for opening up . . . communication channels' between auditors and independent directors. One of the first U.S. studies of the establishment of audit committees concluded that 'the most important functions' of these committees were:

- to discuss with independent auditors any problems and experience in completing the audit,
- to discuss scope and timing of independent audit work,
- to discuss effectiveness of internal controls,
- to discuss meaning and significance of audited figures and notes thereto, and
- to approve or nominate independent auditors. (Mautz and Neumann, 1977, p. 58).

Indeed, during the 1970s and 1980s, much of the technical literature on the subject (usually appearing in accounting journals) emphasized a few key roles: recommending the appointment of auditors, discussing auditors' findings, and reviewing financial statements. There was little questioning of these proposals (though see Perry, 1977).

Consistent with these limited views about the (then) role of audit committees, it was suggested that timing of audit committee meetings should be linked to the audit cycle—with meeting agendas to cover audit plans, and discussions of audit reports and the audit opinion on the financial statements. Tricker (1978) recorded that 'normally audit committees meet two or three times a year'—a sentiment echoed by others (e.g., Priddice and Seaman, 1981). Coopers & Lybrand (n.d., c. 1989) later reported that audit committees of listed clients were meeting between two and four times per year.

The view that audit committees existed to deal with external auditors was later reflected in authoritative guidelines issued by the accounting profession—not in the form of statements about 'best practice' corporate governance, but in guidance to auditors (see, e.g., ASCPA and ICAA, Statement of Auditing Practice AUP 31, *Communications with an Audit Committee*, 1991; AICPA Statement on Auditing Standards SAS 61, *Communication with Audit Committees*, 1998; SAS 90, *Audit Committee Communications*, 1999). For their part, members of those committees may well have 'perceived their job as getting a report on the annual audit and trying to lower audit fees' (Livingston, 2003).

After the establishment of audit committees had been proposed as a solution to past problems and difficulties, acceptance of those proposals meant that the idea was put to the test of experience. It soon became apparent that the mere existence of an audit committee was no panacea. Additional roles were proposed.

Tables 1 and 2 summarize a selection of guidelines or authoritative statements about the *responsibilities* of audit committees, and about recommended *processes*.

It was noted that many guidelines confuse and intermingle statements of *objectives* (or *functions*), statements of *responsibilities*, and statements about recommended *processes* or *operations*. For example, a statement that audit committees should 'review annual financial statements' is not a statement about *objectives*, since it does not explain *why* financial statements should be reviewed (e.g., to ensure the integrity of external financial reporting). Similarly, a statement that members should 'meet with the auditor without management present' is about a recommended process, and has nothing to do with either an objective of the committee, or any of its formal responsibilities.

Space restrictions necessitate limiting the selection of rules or guidelines to eleven documents issued over five decades. The selection includes more items from the U.S.A. than other countries, reflecting the manner in which U.S. bodies have produced more detailed and authoritative materials. Some sets of guidelines (e.g., an Australian *Best Practice Guide* [AARF *et al.*, 1997], or the U.K.'s Hampel Committee report, 1998) were reviewed but not included in the table, because they were couched in vague language and seemed to avoid making clear statements

TABLE 1
AUDIT COMMITTEE FUNCTIONS—AS EXPRESSED IN 'BEST PRACTICE GUIDELINES' OR REQUIREMENTS

Functions of audit committees	AICPA U.S.A. 1967	SEC U.S.A. 1978	Treadway U.S.A. Commission 1987	American Law Inst. U.S.A. 1994	NYSE and NASD U.S.A. 1999	Sarbanes- Oxley Act U.S.A. 2002	Cadbury Committee U.K. 1992	Smith Committee U.K. 2003	Bosch Committee Aust. 1991	Bosch (3rd ed.) Aust. 1995	AARF <i>et al.</i> Aust. 2001
Appoint/replace (external) auditors	X	X	X	X	—	—	X	X	—	X	X
Review audit plan, scope	X	X	X	—	—	—	—	X	—	X	X
Review audit findings, management letters	X	X	—	X	—	—	X	X	—	—	X
Review internal audit scope	—	X	X	—	—	—	X	X	—	—	X
Review internal audit findings	—	X	—	X	—	—	—	X	—	—	—
Review auditor independence	—	X	—	X	—	—	—	X	X	—	X
Approve non-audit services	—	X	—	—	—	X	—	X	—	—	—
Review audit fees	—	X	X	X	—	X	X	X	—	—	X
Review non-audit fees	—	X	—	—	—	X	—	X	—	—	—
Review internal controls	X	X	—	X	—	—	X	X	—	X	X
Appoint/replace internal auditor	—	—	—	X	—	—	—	X	—	—	X
Ensure internal audit adequately resourced	—	—	—	—	—	—	X	X	—	—	—
Coordination external and internal audit	—	—	X	—	—	—	X	—	—	X	X
Communication: auditors and board	—	—	—	X	—	—	—	—	X	—	—
Review annual financial statements	X	—	X	X	X	X	X	X	X	X	X
Review other (e.g., quarterly) reports	—	—	X	—	—	—	X	X	—	X	—
Direct/supervise investigations	X	X	—	—	—	X	—	—	—	—	—
Review accounting policies	—	—	X	X	X	X	X	X	X	—	X
Review accounting opinions sought by management	—	—	X	—	X	X	—	—	—	—	X
Review compliance with accounting standards	—	—	X	—	—	—	X	—	—	—	X
Review compliance with listing rules, laws	—	—	—	—	—	—	X	—	—	—	X
Review compliance with ethics code	—	—	X	—	—	—	—	—	—	—	X
Review officers' expenses	—	—	X	—	—	—	—	—	—	—	—
Review related party transactions	—	—	—	—	—	—	—	—	—	X	—
Review all significant transactions	—	—	—	—	—	—	—	—	—	X	—
Review effectiveness of the external auditor	—	—	—	—	—	—	—	X	—	X	X
Review assessments of risk	—	—	—	—	X	—	—	X	—	—	X

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TABLE 2
RECOMMENDATIONS/REQUIREMENTS ON AUDIT COMMITTEE MEMBERSHIP AND PROCESSES

Membership and processes	AICPA U.S.A. 1967	SEC U.S.A. 1978	Treadway Commission U.S.A. 1987	American Law Inst. U.S.A. 1994	NYSE and NASD U.S.A. 1999	Sarbanes- Oxley Act U.S.A. 2002	Cadbury Committee U.K. 1992	Smith Committee U.K. 2003	Bosch Committee Aust. 1991	Bosch (3rd ed.) Aust. 1995	AARF <i>et al.</i> Aust. 2001
Formal written charter	—	—	—	—	X	—	X	X	—	—	X
Majority of external directors	—	—	—	—	—	—	—	—	—	X	—
Composed of external directors	X	—	X	X	X	X	X	X	—	—	X
Company chairman not to be member	—	—	—	—	—	—	—	X	—	—	X
Some members to have financial expertise	—	—	—	—	X	X	—	X	—	—	X
Appointment limited to three years, max. 2 x 3	—	—	—	—	—	—	—	X	—	—	—
Adequate resources	—	—	—	—	—	X	—	X	—	—	—
Access to external advice from experts	—	—	X	—	X	X	X	X	—	X	—
Members to have access to training	—	—	—	—	X	—	—	X	—	—	X
Right to seek information from management	—	—	X	—	—	—	X	X	—	X	X
Right to consult directly with auditors	—	—	X	—	—	—	X	X	—	X	X
Right of access to internal auditors	—	—	X	X	X	—	X	X	—	X	X
Right to direct auditor: additional work	—	—	—	—	—	—	—	—	—	—	—
Meet auditors without management	X	—	X	X	X	—	X	X	X	X	X
Meet management without auditors	X	—	—	—	—	—	—	—	—	—	—
Meet internal auditors without management	—	—	X	X	X	—	—	X	—	—	—
Investigate complaints from staff (whistleblowers)	—	—	—	—	—	—	—	—	—	—	X
Inform the board of activities	—	—	X	X	X	X	—	X	—	X	—
Minutes to be provided to board	—	—	—	—	—	—	X	—	—	—	X
Charter (periodically) in annual report	—	—	—	—	X*	—	—	X	—	—	—
Committee chairman to report at AGMs	—	—	—	—	—	—	X	X	—	—	—
Review committee's own performance	—	—	—	—	—	—	—	—	—	—	X
Review committee's charter annually	—	—	—	—	X	—	—	—	—	—	X

* The Blue Ribbon Committee recommended that the charter be disclosed at least triennially in the annual report or proxy statement, and in the next annual report or proxy statement after any significant amendment.

or recommendations.⁶ The New York Stock Exchange and National Association of Securities Dealers' Blue Ribbon Committee⁷ report (NYSE and NASD, 1999) was included because of its focus on improving the effectiveness of audit committees, and because it has been seen as influencing subsequent requirements for disclosure of charters and reports on audit committee activities (Nowak and Liang, 2003). Even so, the Blue Ribbon Committee report discussed issues in vague terms, and seemingly avoided stating general principles or offering clear-cut statements on all but a few procedural matters—explaining its view that it was 'not possible to lay down hard and fast rules where discretion is required'.

Considerable licence was exercised in compiling these tables. The AICPA's initial 1967 statement, for example, proposed that an audit committee should 'invite the auditors' recommendations regarding internal controls and other matters'; others referred to the need to review the auditors' management letter. These have been combined in Table 1 as 'Review audit findings and management letters'. Table 1 summarizes, in abbreviated form, the principal responsibilities of an audit committee, but does not explore how those functions might be exercised. For example, the SEC (1978) referred to an audit committee's role as *recommending* the engagement or discharge of auditors (implying that the full board might endorse that recommendation, before seeking stockholders' approval). These steps are summarized as 'Appoint/replace (external) auditors'.

Conversely, items are included as a function (and hence a responsibility) of the audit committee even when particular guidelines suggest that other board subcommittees might equally perform those functions (e.g., the U.K.'s Smith Committee⁸ proposed that an audit committee should review risk management systems 'unless addressed by a separate risk committee or by the board itself').

With these qualifications, Table 1 illustrates how authoritative opinion about the role of audit committees has moved away from focusing on the relationship between auditors and directors in connection with the preparation of financial statements, towards proposals for greater oversight of management (or what might be termed 'internal governance').

Some of the additional responsibilities proposed in the various 'best practice' guidelines seemed to reflect 'issues of the day'—an approach also reflected in some parliamentary committee reports and some contributions to technical journals.

⁶ AARF *et al.* (1997) simply listed topics which could be considered for inclusion in an audit committee's charter, without expressing any clear position on these issues. The Hampel Committee (1998) was also noncommittal: for example, 'we suggest that the audit committee should keep under review the overall financial relationship between the company and its auditors, to ensure a balance between the maintenance of objectivity and value for money'.

⁷ The Blue Ribbon Committee was chaired by the CEO of the New York Stock Exchange, and its other ten members included representatives of the National Association of Securities Dealers, the corporate sector, major accounting firms, an attorney, a retired investment banker, and a former Comptroller General of the U.S.A., Charles Bowsher.

⁸ Apart from Sir Robert Smith, chairman of an engineering firm, membership of the Smith Committee included two chief financial officers, three representatives of accounting firms, and one former investments manager of an insurance company.

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Examples of proposals which have not been repeated or supported by other authorities are:

- AICPA's (1967) suggestion that audit committees should review the overall 'financial structure' of a corporation;
- Treadway Commission's (1987) recommendation that members of audit committees 'should have sufficient understanding of computers to exercise oversight responsibilities';
- Bosch Committee's (1991) recommendation that audit committees review 'major transactions'; and
- AARF *et al.*'s (2001) suggestion that audit committees are usually concerned with 'financial management' and 'business policies'.

Examples of practices reported to have been assumed by some U.S. audit committees (Vanasco, 1994) include:

- reviewing corporate policies,
- conducting reviews of litigation or regulatory proceedings,
- performing or supervising special investigations,
- reviewing executive expenses, and
- reviewing policies on sensitive payments.

Again, these proposals have not been repeated or supported by 'best practice' guidelines, though arguably some deserve board scrutiny.

Overall, while there has been a shift in ideas about what audit committees should do—and a commensurate broadening of recommendations in authoritative guidelines—the advocacy literature has not fully responded to revelations of some fundamental shortcomings in governance arrangements.

GAPS IN THE GUIDELINES

Historically, there has been a strong association between corporate collapses and disasters, and proposals for strengthened corporate governance arrangements. This link has been well documented (see, e.g., CICA, 1981; Wolnizer, 1995). Yet some of the common findings from reports on the background to those collapses have not been addressed.

Structure and Design of Delegations

The history of corporate failures includes many stories of how chief executives had committed corporations to major transactions without seeking the prior approval of the board—followed by major losses in those deals. (For Australian examples, see the histories of corporate failure described in Sykes, 1988; Gotterson, 1989; and in Clarke *et al.*, 2003. Similar reports have been heard from directors of more recently failed Australian companies, notably One.Tel and HIH Insurance.)

Such instances highlight a failure by boards to establish appropriate delegations, and in particular, to reserve the authority to approve certain types of transactions to meetings of directors.

It is accepted practice that organizations should establish, and regularly review, schedules of delegations. Such schedules generally establish limits to the authority of individual officers to incur expenditure, and may be linked to a board-approved budget. Moreover, schedules of delegations can require managers to provide early warning signals to senior executives or boards when it becomes clear that patterns of expenditure suggest that capital or operating budgets are likely to be exceeded (even though expenditure to date is 'within budget').

The establishment (and regular revisions) of schedules of delegations can be seen as an important and critical element of an organization's internal controls—so critical that it warrants special mention and attention in the charter of audit committees. Yet none of the formal guidelines on the establishment of audit committees, reviewed above, mentioned this topic.

Adequacy of Information Going to the Board

A recurring feature of many corporate failures (and of the experiences of a host of companies that have survived after massive losses and asset write-downs) is that apparently competent and knowledgeable directors complained that they had been misled by management. Consequently they had allowed companies to continue to operate businesses which should have been abandoned; they sanctioned ongoing investments in failing ventures without recognizing that they were only throwing good money after bad. In other words, these companies had *inadequate internal accounting systems and reporting arrangements*.

It may be extremely difficult for directors to recognize when information they are being supplied is defective, and overly optimistic. Directors, for their part, are not in a position to 'audit' the quality of information flowing to them—that properly should be left to internal or external auditors. But nor can auditors routinely assess the adequacy of internal reporting arrangements unless that topic is included in an agreed audit plan. And that is where proactive audit committees can ensure that such issues are examined on a regular basis.

Most contributions to the extensive corporate governance literature appear to have assumed that the audit committee's concerns are restricted to external reporting. Even authors exploring 'financial reporting quality' (Krishnamoorthy *et al.*, 2002) have focused exclusively on reporting to external stakeholders.

Only a few contributors have argued that audit committees should examine the adequacy of the flow of information to senior management and boards. Coopers & Lybrand (n.d.) put it this way:

The effectiveness of a Board depends to a large extent upon the quality of the information which it receives. Therefore, it needs to ensure that adequate information systems are in place at appropriate levels for management decision making purposes. We believe that audit committees can make an important contribution here by making sure that the Board as a whole—and perhaps especially its non-executive members—are receiving relevant and reliable information, and at the right time, in order to monitor the business and on which to base important decisions. (p. 6)

Similarly, English (1994) argued that it was 'incumbent on boards to ensure that corporate information systems (of which the financial information system is

merely a subset) are capable of delivering untainted information to them', and suggested that 'it is in monitoring information systems (in conjunction with internal and external auditors) that directors play a vital role in corporate governance and ensure compliance with the law' (p. 18).

Yet it appears that no 'best practice' guidelines have addressed this issue in any detail. The Cadbury Committee, for example, proposed that boards 'should regularly review the form and the extent of the information which is regularly provided to all directors' (1992, para. 4.14)—note the reference to 'form' and 'content', but not quality. The Cadbury Committee also suggested that responsibility for ensuring that non-executive directors 'receive timely, relevant information tailored to their needs' rested with the chairman (para. 4.8). The Hampel Committee (1998) was content to assert the principle that 'the board should be supplied in a timely fashion with information in a form and of a quality appropriate to enable it to discharge its duties' (Principle IV)—but without suggesting that an auditor committee (or for that matter, the board) would have a role in ensuring that such a principle was put into effect.

Of the guidelines reviewed, the closest any came to identifying an audit committee role in relation to the quality of reporting to boards was the American Law Institute's (1994) proposal that a function of audit committees should be to review 'the corporation's processes for producing financial data'. That could be interpreted as encompassing the production of monthly management accounts.

Statements of auditing standards issued by the auditing profession have made passing reference to the need for auditors to communicate their concerns about 'material weaknesses in . . . accounting and internal control systems' (U.K. APB's SAS 610, 2001, para. 33)—but accompanying discussion linked these concerns with external reporting only. Similarly other documents issued by the profession to provide 'guidance' to audit committees have focused on regulatory requirements governing external reporting, and have disregarded the quality of reporting to boards (see, e.g., ICAEW, 2003).

A distinction may perhaps be drawn between the data routinely provided from accounting and financial reporting systems about operating activities, on the one hand, and the data presented to support new investment proposals. Arguably both should be the subject of attention from an audit committee. The latter might be examined in 'post investment reviews'. However, it is surprising that the 'best practice' guidelines do not suggest a role for audit committees in reviewing the quality of either form of internal financial reporting.

Oversight of Subsidiaries or Other Associated Entities

There is little point in having an audit committee review the formal financial statements of a holding company if major components of earnings are derived from subsidiaries or associates—and there has been no equivalent scrutiny of the accounting methods used to calculate those earnings. Indeed, a related finding from reports of corporate collapses has been that directors have been inadequately informed or misled about the activities of subsidiaries and associates—or what are now, post-Enron, called 'special purpose entities'.

This topic has been little discussed in the technical literature on audit committees—and most references have been along the lines that having audit committees of listed companies should focus on consolidated financial statements: ‘Where a group is diversified and multinational, the audit committee concentrates more on major matters and accounting issues at consolidation level. This is particularly true of groups in which management is decentralised and strong local autonomy exists’ (Coopers & Lybrand, n.d.). Tricker (1978) quotes from an interview with the CEO of a ‘world wide conglomerate’: ‘we, in the holding company, can relax with an audit committee in the subsidiary. It is part of our control mechanism’ (p. 63).

However, there is considerable evidence to suggest that a focus ‘at consolidation level’ may be hazardous. Indeed, there have been well-documented instances where the boards of listed companies were unaware of the overall financial position of a ‘group’ of controlled entities or had not been provided with information about the results of associated companies for extended periods (see, e.g., Shaw, 1966; Gotterson, 1989). In other cases (notably Equity Funding—see Seidler *et al.*, 1977; Friedman, 1997) foreign subsidiaries were used to fraudulently generate paper profits.

Shareholders may well be reassured by the presence on an audit committee of independent directors of the parent entity, yet such arrangements may be ineffective when the main operations of a business are operated by subsidiaries, oversights by audit committees composed solely of management and executive directors (as was the case in the recently failed Australian company, Harris Scarfe).

At a minimum, it is considered necessary for audit committees to review the accounts of the individual subsidiaries that are to be consolidated, to ensure consistency of accounting policies (or even that those accounts have been professionally audited—there have been instances where management had failed to disclose to directors that an audit firm had not completed its audit assignment for a major associated company).

Alternatively, reliance might be placed on the existence (and activities) of audit committees in subsidiaries that are composed of external directors, including some with financial skills. The American Law Institute (1994) took this stance: it asserted that ‘the audit committee of the parent can reasonably rely on the audit committee of the subsidiary’ (p. 118). But that may not be reasonable if, for example, the charter and activities of a subsidiary’s audit committee are not consistent with those of the parent.

The Sarbanes-Oxley Act has formally addressed this issue by making CEOs and CFOs responsible for financial reports and internal controls (including controls relating to the receipt of information from subsidiaries):

- (A) are responsible for establishing and maintaining internal controls;
- (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
- (C) have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and
- (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date. (Section 303(a)(4))

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However, contemporary 'best practice' guidelines do not refer to any steps that might be taken to ensure confidence in the quality of information being presented to boards or external stakeholders regarding subsidiaries and associates. Indeed, most guidelines even fail to refer to governance arrangements in subsidiaries. One exception was Ernst & Young's 1999 model charter for an audit committee (reproduced in the Blue Ribbon report, NYSE and NASD, 1999) which proposed that the committee should recommend the auditors of 'the corporation, its divisions and subsidiaries'. Yet, given that directors of majority owned subsidiaries have an obligation to act in the best interests of all shareholders of those corporations (see Ford *et al.*, 1999, pp. 113ff.; CASAC, 2000, pp. 43ff.), such recommendations may not always be accepted. The audit committee charters of some U.S. corporations simply assume that parent and subsidiary companies will have common auditors (see NYSE and NASD, 1999).

ROLE AND ACTIVITIES OF AUDIT COMMITTEES—IN PRACTICE

There has been no shortage of surveys of incidence of audit committees and reviews of their stated responsibilities. Professional firms have incorporated surveys of practices in booklets about audit committees, to convey the sense that they had become accepted and to encourage greater adoption. Academics have also reviewed the disclosures made by listed companies relating to the existence, composition or operation of audit committees in the U.S.A. (e.g., Mautz and Neumann, 1977; Carcello *et al.*, 2002) and in Australia (e.g. Simnett *et al.*, 1993; Moroney and Simnett, 1996; Arkley-Smith, 1999; Baxter and Pragasam, 1999; Carson, 2000). Comparatively few surveys have been undertaken in the U.K. (e.g. Tricker, 1978, 1984; Collier, 1993; see also Collier, 1996). While many of these studies were largely descriptive, rather than presenting any critical analysis or assessment of the activities of audit committees, they do indicate the way that the responsibilities assigned to these board subcommittees have expanded over past decades, consistent with overall developments in the advocacy literature on corporate governance.

A further survey was undertaken to assess whether contemporary practices have kept pace with recent proposals about the responsibilities of audit committees—in the context of Australian Stock Exchange listing requirements which, in 2002, placed pressure on listed entities to establish audit committees without detailing what audit committees should actually do.

Accordingly, information about contemporary practices was obtained from a review of the annual reports of what were, at June 2002, the top 200 listed entities by market capitalization (as reported in a contemporary report from the magazine *Business Review Weekly*). A total of 196 annual reports for financial years ending in 2002 were obtained; the four that were unobtainable were for entities that had been delisted following mergers or takeovers, so for these entities, reference was made to 2001 annual reports.

Overall, all but eight of the sample (98 per cent) reported that they had established audit committees (or a similarly-titled body)—for the others, the responsibilities of an audit committee were assumed by the full board.

These entities were required by ASX Listing Rule 4.10 to describe the main corporate governance practices they had 'in place'.⁹ 'Best practice' guidelines almost unanimously recommend that audit committees should have a written charter. However, Australian listed entities were at that time not required to place the charter of their audit committees on the public record.¹⁰ Forty-nine per cent of those entities with audit committees reported that a charter existed, but only 7 per cent either provided the charter in their annual report or advised that a copy was available on request. Overall, for the 192 listed entities with audit committees, information about the responsibilities assumed by those committees was obtained from either a summary included in the annual report or by reference to the charter.

The disclosures provided for these 192 entities revealed the following:

- 85 per cent reported a primary responsibility to review financial statements—sometimes before they were forwarded to the full board (though 4 per cent had been delegated authority to approve the financial statements for publication).
- 53 per cent of audit committees reported that a key function was to monitor risk assessment processes or plans. However, the nature of the risks identified as being reviewed by the audit committee varied considerably: some firms referred only to financial risks, and others to legal and regulatory risks—implying that they did not review 'operational' risks. A few entities had separate 'risk and compliance committees', while a few others reported that risk assessments were undertaken by the board as a whole.
- 48 per cent reported that the audit committee's role was to recommend the appointment of the auditor.
- 63 per cent reported that they monitored the auditor's work, variously referring to audit plans, or audit scope. Of this group, a surprising 42 per cent indicated that they *evaluated the performance of the auditor or the quality of audit work*. Such a role has been suggested on occasion (e.g., Richards, 2001), and has only featured in the more recent 'best practice' guidelines reviewed above (and then only obliquely¹¹). Major accounting firms have recently listed 'evaluating the performance of the external auditor' as a relevant function of an audit committee (see, e.g., PriceWaterhouseCoopers, 1999; Deloitte Touche Tohmatsu, 2003). However, no listed entity explained how they performed such an exercise, or what criteria were used in the process.

⁹ These requirements were amended in January 2003 to require all listed entities that were included in the S&P/ASX All Ordinaries Index at the beginning of its financial year to have an audit committee—see ASX Listing Rule 12.7.

¹⁰ Later the ASX Corporate Governance Council (2003) proposed that the audit committee charter 'should be made publicly available, ideally by posting it to the company's website' (p. 33).

¹¹ For example, AARF *et al.* (2001) proposed that the committee should 'make recommendations to the board on the appointment, remuneration and *monitoring of the effectiveness* and independence of the external auditor' (p. 24, emphasis added). Both the ASX Corporate Governance Council's statement of 'principles of corporate governance' (2003) and Australian Council of Superannuation Investors' *Corporate Governance Guidelines* (2003) proposed that audit committees should 'assess the performance and independence of external auditors'—though these were issued after publication of the annual reports reviewed here.

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- *Only 19 per cent reported that the internal auditor reported to the audit committee* (though many of the entities in the sample—particularly investment trusts—may not have engaged internal auditors). One company's audit committee reported that it undertook the internal audit function itself.
- *Only 9 per cent reported that the audit committee reviewed management responses to audit recommendations*—yet without 'follow up', issues raised by auditors may not be properly addressed in a timely fashion.
- Contrary to the AARF *et al.*'s (2001) 'best practice' guidelines, *only 5 per cent reported that they reviewed related party transactions* (of which only 2 per cent 'pre-approved' RPTs¹²). Overall, 181 (90 per cent) of the top 200 listed entities disclosed in their financial statements that they had entered into RPTs (including 30 per cent reporting loans or other transactions that were not for a 'commercial' consideration). Possibly the full board of these entities reviewed RPTs, or the companies concerned did not bother to explain their processes, but the lack of attention to this aspect of corporate governance may be viewed with concern.
- *Only a handful of companies (2 per cent) reported that the role of the audit committee encompassed assessing the quality of internal financial reporting to the board*, while only an additional 2 per cent reported that they undertook post-audits of major capital investments.
- While many audit committees referred to the 'group accounts' or the financial statements of an 'economic entity', *less than 2 per cent provided clear explanations of how they ensured that the integrity of the financial information provided about subsidiary companies* (i.e., by having separate audit committees for those entities, and establishing common standards for audit committee procedures). On the other hand, 14 per cent indicated that the committee's concern was solely with the consolidated entity.
- Instances were noted of audit committees reporting that their responsibilities involved reviewing corporate budgets, funding commitments, documentation relating to 'offers of equity', matters outstanding at the Australian Tax Office or with the Australian Securities and Investments Commission, executive directors' personal expenditure, dividend policies, business continuity planning, and benchmarking of operational key performance indicators.
- No instances were noted of audit committees providing a channel for communications from whistleblowers about such matters as fraudulent conduct or misleading reporting.

It should also be recorded that very few listed entities did more than summarize the 'charter' of their audit committees in their annual reports—outlining key responsibilities, and some key procedures (such as meeting auditors without management present, or arranging for audit partner rotation). While contemporary 'charters' of audit committees may occupy several pages of text (see appendixes to the Blue Ribbon report, NYSE and NASD, 1999), the costs of reproducing that material in annual reports would be minimal. Further, few companies report both

¹² One company had a separate 'related party committee' to review such transactions.

the formal qualifications and experience of directors, so that it is not possible to assess whether members of audit committees are appropriately skilled.

Reports about the activities of Australian audit committees were fairly sparse, with only a few reporting how many times they had met. Those disclosures were in themselves alarming. A sample:

- Aristocrat Leisure reported that its audit committee met ‘at least twice a year’;
- CSR’s audit committee met three times during the year, but was planning to meet four times next year;
- BRL Hardy reported that it met three or four times a year ‘on average’;
- Caltex’s audit committee met ‘at least three times’ per year;
- Lend Lease avoided disclosing how many times its risk and compliance committee had met—reporting only the total number of meetings held by all board committees, in aggregate.

In the 1970s, when audit committees performed only basic functions, it was suggested that they should meet four to six times annually—escalating to monthly meetings if they were to assume greater responsibility for receiving reports from internal auditors and becoming involved in an organization’s public reporting, operations, policies and procedures (Perry, 1977). Others have suggested the relationship between audit committees and internal auditors must be ‘year-round’ (Rezaee and Lander, 1993). Hence reports that contemporary audit committees of firms engaged in large and complex businesses are meeting only two or three times a year suggest that members are devoting little attention to the wide range of responsibilities they claim to be addressing.

It is also noteworthy that U.S. surveys of audit committee members have found that members were generally not able to recognize their assigned responsibilities as detailed in formal, written charters (De Zoort, 1997). This observation has been confirmed by recent research findings from the U.S.A., where audit committee charters must be placed on the public record, and where reporting about audit committee activities is more extensive. It was found that what audit committees say they are doing in their reports differs from what their charters say they should be doing—with a major shortcoming being the failure to oversight the content of interim reports (Carcello *et al.*, 2002).

To date it has not been possible to replicate those studies with a representative sample of major Australian listed entities, since (as noted above) less than 8 per cent published the charter of their audit committees, or made it available. Telephoned requests to several major listed entities for copies of their audit committee charters were rejected, on grounds that this information is ‘confidential’—even though adoption of the 2003 ASX Corporate Governance Council report has meant that disclosure will be mandatory from 2003 for all entities on the S&P/ASX 500 All Ordinaries Index (see pp. 30–3). In future, shareholders may be better placed to assess the performance of incumbent directors. However, from the perspective of directors, the risk that important tasks may be overlooked could perhaps be averted by the adoption of a simple procedure: the development of a ‘calendar’ detailing topics to be considered in audit committee meetings during the year.

A MODEL CHARTER FOR AN AUDIT COMMITTEE

Very few contributions to the advocacy literature on audit committees have translated their observations about what audit committees should do into statements about what the 'charter' of such a committee should encompass. There are some exceptions (e.g., Tricker, 1978, Cadbury Committee, 1992; Coopers & Lybrand, n.d., pp. 18ff.; Smerdon, 1998; and the U.K.'s Smith Committee, recommendations on amendments to the post-Cadbury 'Combined Code', Financial Reporting Committee, 2003) though many of these proposals already seem inadequate, relative to contemporary expectations. Other contributions (such as AARF *et al.*, 1997) have simply listed issues that an audit committee charter should 'cover', if thought appropriate—reflecting, perhaps, an inability of committees to reach agreement.

An appendix to this article sets out a suggested model charter, which builds on the work of others. In compiling this document, a series of prior exercises were consulted, including 'best practice guidelines' (Cadbury Committee, 1992; Bosch Committee, 1995; NYSE and NASD, 1999; AARF *et al.*, 2001; Smith Committee, 2003) and other contributions (e.g., CICA, 1981; Smerdon, 1998). In reviewing these materials, judgments were necessarily made about the appropriateness of including some matters. For example, some published charters emphasized that the committee should focus on 'significant audit findings' without any explanation of what the term 'significant' might entail. Accordingly, clauses of this type were disregarded.

The major differences between the accompanying model charter and prior work is that (a) the charter adopts a wide-ranging view of the responsibilities of audit committees (i.e., more than simply 'dealing with auditors') and (b) it seeks to address the major gaps in authoritative guidelines that were identified above.

The *structure* of the document also differs from prior work. As noted above, several previously published model charters have confused and intermingled statements of the purpose (or 'objectives' or 'functions') of audit committees, with statements about their *authorities*, *responsibilities*, and statements about the *processes* that committees might follow. Some model charters suggested by major accounting firms have since addressed this deficiency (see, e.g., PriceWaterhouseCoopers, 1999; Ernst & Young, 2003). The approach adopted here was to separate the main elements of a charter (statements about objectives, responsibilities and authorities) from proposals about procedures.

Issues relating to the membership, qualifications and independence of members of audit committees were not examined in detail, as these issues do not relate to the purpose and responsibilities of an audit committee. Contemporary expectations are that board members of audit committees should be non-executive directors (and the Sarbanes-Oxley Act made this mandatory). However, in some situations audit committees may be more effective if they include or engage independent experts from outside the ranks of directors. Overall, broad issues relating to the structure and composition of board subcommittees would be addressed in statements about 'best practice' corporate governance, and in statements by company boards about their governance practices. For convenience, an audit committee

charter could include a statement about committee membership (as illustrated in the model charter).

However, it is suggested that contemporary requirements for the inclusion of at least one 'financial expert' on an audit committee (Sarbanes-Oxley Act, 2002; ASX Corporate Governance Council, 2003) may not go far enough. Moreover, as has been observed, in relation to Enron, 'meeting the textbook definition of financial literacy is not a guarantee that directors understand sophisticated financial instruments'—there is a need for industry-specific training (Lavelle, 2002). Some have suggested that requirements for 'financial expert' be changed to 'financial reporting expert' (Livingston, 2003), that in itself implies a narrow conception of an audit committee as focusing on external reporting. It is considered that audit committees (like boards) may need members with a range of skills and experiences if they are to be effective. For certain tasks (such as risk assessment) the best qualified members may well be those with practical management experience and industry knowledge, not those with a financial or accounting background (Olson, 1999). But the identification of criteria for determining membership of audit committees is beyond the scope of this article.

Some cautionary observations and qualifications. It is not suggested that the accompanying model charter is relevant to every firm—plainly certain elements will not be relevant to every organization. Some firms, for example, may not operate an internal audit function. Some firms in specialized businesses may prefer to have specialist committees (e.g., firms in the financial services industry may establish separate compliance committees). It may be that some issues have been overlooked—indeed, that is only to be expected, as regulatory changes impose new obligations on the boards of corporations. The drafting may well be improved. More comprehensive charters may already be in use. Some may disagree with the contents of the proposed model charter, since it (and the accompanying set of model procedures) takes a stance on a number of issues, of which six were identified above as 'gaps' in authoritative guidelines. A further five issues are described below, along with a discussion of some procedural matters.

Decisions About the Choice of Accounting Methods

Since Australian corporations law requires directors to make certain representations about the content of financial statements, this may seem a surprising inclusion. However, many commentators have avoided stating that directors (or audit committees—if delegated that responsibility by a board) have a responsibility to choose what accounting methods are to be adopted. Rather, commentaries have suggested that audit committees should only 'focus on significant changes in accounting policies [and] major judgment areas that have had to be resolved': 'The audit committee should not be expected to be an arbiter between the auditor and management on such issues, but could usefully be made aware of them' (Coopers & Lybrand, n.d.). The same accounting firm reported that in its experience 'it is common for audit committees to review changes in accounting policies proposed by management or auditors, but there is little evidence that audit committees play a part in identifying policies requiring revision or in the initial formulation of policies for new activities or transactions' (p. 6).

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The notion that directors were only interested bystanders while management made accounting choices was eroded somewhat when the Treadway Commission proposed that audit committees should review accounting opinions sought by management—a proposition repeated by the NYSE and NASD Blue Ribbon Committee (1999). Yet even those statements imply that directors need only review (and possibly endorse) management's accounting choices, not determine those accounting choices themselves. As Wolnizer (1995) observed, these proposals suggested that audit committees would be 'forming opinions of (accounting) opinions rather than opinions based on dated financial facts' (p. 63).

Accounting standards in the U.S.A., U.K. and Australia all require that financial statements be accompanied by a statement of 'accounting policies' in notes to the accounts. In practice, most of the material reported under that heading simply reiterates extracts from the text of accounting standards, rather than explain the *policies* actually adopted by firms in interpreting those standards (e.g., what are the thresholds for capitalizing rather than expensing certain expenditures?). Nor do published reports fully explain the immediate and subsequent impact of those policies on reported profits. These matters have not, to date, been the subject of regulatory attention.

However boards of directors, by authorising the signing of accounts containing such statements, are already taking responsibility for this material.

Thus there is some inconsistency between the claims made about directors' responsibilities for accounting choices in audit committee guidelines, and in the corporations law. Arguably, the statements are reconcilable if one assumes that directors are simply signing statements they do not understand—having diligently made enquiries and relied on advice from 'experts'. To those investors who rely on published financial information when making investment decisions, this is plainly an unsatisfactory situation—and suggests that boards are unbalanced and lacking in essential skills.

In the U.S.A., the Sarbanes-Oxley Act has clarified the role of the audit committees of listed public companies in relation to accounting choices. Auditors are to report to audit committees:

1. all critical accounting policies and practices to be used;
2. all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials . . . , ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
3. other material written communications between the registered public accounting firm and the management of the issue, such as any management letter or schedule of unadjusted differences. (Section 204)

Audit committees, in turn, are to be responsible for 'oversight of the work of any registered public accounting firm employed by the issuer', 'including resolution of disagreements between management and the auditor regarding financial reporting' (s. 301(2)). Even so, these requirements (while an advance on the Treadway Commission's view of directors' responsibilities) still do not make directors directly responsible for the *choice* of accounting treatments adopted in the accounts.

Under the Sarbanes-Oxley regime, directors would only get involved if they found out about disagreements between management and auditors over accounting issues, or disagreed with what someone else identified as a 'critical' accounting policy. The Sarbanes-Oxley Act also shifts responsibilities from boards by requiring CEOs and CFOs to certify that they have reviewed financial reports, and that, to their knowledge, the reports do not contain any untrue statements of a material fact or omit to state a material fact in order to make the statements 'not misleading' (section 302(a)). That is a remarkable requirement, insofar as it makes no reference to information being 'presented fairly in terms of 'generally accepted accounting principles'—the accounting profession's preferred form of words to describe the quality of external financial reports. The new test may make compliance with these requirements more readily enforceable, since written assertions by company officers can be tested against evidence (rather than against opinions about how the concept of 'generally accepted accounting principles' should be interpreted).

Arguably, the Sarbanes-Oxley Act's requirements have placed greater responsibilities on directors, while also imposing more onerous requirements on auditors, CEOs, and CFOs.

The model charter assumes that directors accept oversight responsibility for the selection of accounting policies. This merely reflects the legal position whereby, in terms of the Australian Corporations Act, directors may satisfy their obligations in relation to financial reporting, as in other matters, by 'informing themselves about the subject matter of the judgment to the extent that they reasonably believe appropriate' (see Lumsden, 2002).

Engagement of External Auditors

The extent to which auditors' independence is compromised by their involvement in the delivery of non-audit services has been the subject of extensive discussion related to the Enron affair, with the Sarbanes-Oxley Act introducing restrictions that are likely to appear in other jurisdictions.

While there may be concerns raised about auditors' involvement in some consulting activities, it is difficult to see any difficulty with arrangements requiring auditors to undertake a more comprehensive and searching audit than that required by regulatory requirements. There appears to be no impediment to audit committees proposing that auditors undertake a thorough program of reviewing internal controls, for example—that would simply involve more 'auditing' than a statutory audit. Auditors might also be engaged to undertake some checks for fraudulent activity, or to assess whether the consideration in proposed related party transactions was 'fair and reasonable'.

Implicit in the model charter is the proposition that the firm—not the auditors—should prepare 'letters of engagement', clarifying the scope of an audit engagement.

Relationship With Internal Auditors

As Table 1 shows, some contemporary guidelines suggest that audit committees should be responsible for the engagement of internal auditors; and that internal auditors should report directly to them. While this proposal has been supported in

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the internal auditing literature (see, e.g., Braiotta, 1982), others had suggested that 'operational direction of internal auditors, like other operational matter, is properly a management responsibility and should not usually involve the audit committee' (Coopers & Lybrand, n.d., p. 8).

Contemporary expectations seem to be that if internal auditors are to review internal controls or compliance issues, then the audit committee should be fully involved in appointing internal auditors, reviewing the internal audit plan, and assessing the adequacy of the resources to be devoted to specific projects. Audit committees should also directly receive reports from those auditors (be they full-time employees or contractors).

In other words, the internal auditors should report to the audit committee, not only to management. This view is expressed in the model charter. It follows that an appropriate procedure to be followed by internal auditors is to provide reports (including draft reports) to management and the chair of the audit committee at the same time.

Some might see this as creating tensions between management and boards, as the internal auditor becomes an arm of the audit committee rather than a service to management. Management may wish internal audit to review the efficiency and effectiveness of functions or divisions within an organization. But there seems no barrier to management 'bidding' for the use of internal audit resources to undertake those projects, and for management and directors to reach agreement about priorities during meetings of the audit committee. This would ensure clear lines of authority, and avoid internal auditors facing divided responsibilities: reporting both to management and to a subcommittee of the board.

Reviewing Risks

Recent guidelines issued in the U.S.A., the U.K. and Australia suggest that audit committees should have the role of assessing risks facing an organization. Plainly the assessment of risks is an important function of both managers (to devise plans for managing those risks) and for boards (to oversight management plans and processes). External auditors also need to assess risks when devising audit plans.

However, a distinction can be drawn between *financial* and *operating* risks. Arguably, audit committee involvement in risk assessment should be limited to the areas in which financial specialists can contribute insights, and avoid areas warranting the involvement of other specializations.

Acceptance of the proposition that an audit committee is a forum to assess risks facing the organization does not mean that directors are unduly involving themselves in management. However, arguably directors should resist efforts by auditors to pass full responsibility for risk assessment to the audit committee, or to the board.

Pre-Approval of Related Party Transactions

While the Australian accounting profession was tardy in introducing accounting standards dealing with the disclosure of related party transactions (RPTs; see Walker and Robinson, 1994), the nature and extent of such dealings has been of recurring

interest in the Australian securities market—particularly following belated revelations about transactions involving directors of Qintex, Bond Corporation and Coles-Myer. Disclosure of such transactions after the event provides little assurance to investors that their interests are not being damaged by such deals, particularly since accounting standards or other regulatory requirements do not require auditors to express a view as to whether the consideration being provided is fair and reasonable.

A few commentators have either warned of the challenges to audit committees arising from major transactions involving the payment of underwriting fees or management buy-outs (Bows, 1987) or suggested that the responsibility for reviewing RPTs could be assumed by audit committees (e.g., English, 1994).

While the Corporations Act incorporates some requirements for some major related party transactions to be subject to prior shareholder approval, there is still room for other transactions, in the form of commissions, fees, supply and purchase arrangements, to be undertaken without such consent. Many will be described as being undertaken in accordance with ‘normal commercial terms and conditions’, but perceptions may differ as to what is ‘normal’ in the world of commerce.

Only Australian guidelines have directly addressed this issue, with AARF *et al.* (1997, 2001) agreeing that the committee’s responsibilities could encompass reviewing and monitoring ‘the *propriety* of all related-party transactions’.

A more effective requirement would be for audit committees to be required to *pre-approve* such transactions. Ongoing arrangements (e.g., for the routine purchase of goods or services from related parties) could be subject to annual review. To ensure that the review process is taken seriously, the audit committee could maintain a register of all requests for approval, and how those requests were determined.

Procedures

The contents of the accompanying model charter are largely self-explanatory, but a few points may be worth noting.

- In order to satisfy directors’ obligations to act diligently, it is appropriate that the audit committee take steps to ensure all of the matters that the charter contemplated will be addressed (Lumsden, 2002), and that adequate meeting time is available for the consideration of major issues (Olson, 1999). Hence one recommended procedure is for the development of a ‘calendar’ or schedule of topics for consideration during a year’s meetings.
- It has been suggested that a major objective of an audit committee is to ‘follow up on allegations of material, financial, ethical and legal irregularities’ (Sheridan and Kendall, 1992). The Enron experience has highlighted the inability of ‘whistleblowers’ to communicate their concerns about distortions in financial reports through normal communication channels within an organization; similar experiences have been documented in Australia (Dempster, 1997). That deficiency has subsequently been addressed by the Sarbanes-Oxley Act through requirements for audit committees to establish procedures for the ‘receipt, retention and treatment’ of complaints—without specifying what those procedures might entail. Given alarming findings that nearly two-thirds of employees may

know of improper behaviour yet choose not to report it (Priest and Kaplan, 2002), a combination of formal processes and cultural reinforcement may be required for whistleblowing channels to be utilized. The accompanying set of model procedures suggests one approach for handling the former.

- Internal and external auditors may believe they have identified weaknesses in internal controls or reporting arrangements, and management may disagree or disagree with those conclusions or with recommendations on how those matters should be addressed. In complex organizations, the number of audit points raised during the course of a year may run into the hundreds, and there is a risk that matters may be given only cursory attention, overlooked, or forgotten. The proposed procedures allude to the establishment of a register to record issues raised by auditors, the contents of which may be provided to the committee. The idea is to establish a discipline whereby audit points are not overlooked, and that follow-up action is initiated where appropriate.

While it is contended that the model charter may be an advance on some contemporary examples, inevitably it could be refined in the light of changing expectations and experience. It may be, for example, that technological changes warrant an expansion of audit committee responsibilities into areas of IT governance.

CONCLUDING OBSERVATIONS

Regulatory pressure from the Australian Stock Exchange—requiring listed entities to disclose whether they have audit committees and ‘if not, why not?’—has made the formation of this form of board subcommittee almost universal amongst major Australian listed firms by 2002. That reflects a major change over the past decade: only 13 per cent of listed companies had audit committees in 1990 (Simnett *et al.*, 1993). But that does not mean that these arrangements have or are making effective contributions to the governance of listed entities.

The failure of the ASX to spell out minimum terms of reference for an audit committee has meant that, in many respects, the operations of Australian audit committees may be falling well short of ‘best practice’—if the statements in annual reports about the activities of audit committees are to be taken as reflecting a consensus on that issue. Certainly the majority of major listed Australian companies do appear to be assuming all of the responsibilities proposed for them in recent guidelines.

The ASX has subsequently made audit committees compulsory for major listed companies (those on the S&P/ASX All Ordinaries Index), and the ASX’s Corporate Governance Council’s recent statement (March 2003) may encourage greater attention to be focused on the responsibilities of boards generally, and on board subcommittee’s in particular. However, the opportunity was missed to require disclosures that would enable greater scrutiny to be focused on what boards are actually doing on behalf of shareholders. Unless copies of audit committee charters are publicly available, and unless annual reports clearly describe the activities undertaken by audit committees, then investors will be unable to ask informed questions of boards and generally hold directors accountable.

However, regulatory reform is best preceded by an analysis of defects in existing arrangements. Recent Australian initiatives seem to have been developed without prior analysis of the failure of governance arrangements in major corporations that have failed or encountered financial distress or incurred major losses through failed investments or capital projects. But, based on prior experience, it is clear that one factor contributing to the scale of these disasters was that boards received financial information that was, at best, inadequate (or, at worst, misleading).

'Best practice' guidelines on the operation of audit committees have not addressed this issue—rather, they have focused on external reporting. The accounting profession has issued standards for external reporting, not for management accounting and reporting to boards.

While the Sarbanes-Oxley Act required CEOs and CFOs to certify that financial information they have prepared is 'not misleading', that has been watered down locally to a statement that financial statements are 'in accordance with accounting standards' and presenting a 'true and fair view' (ASX Corporate Governance Council, 2003). While 'best practice guidelines' have not discussed the role of audit committees in monitoring the quality of information going to boards, it is encouraging that some corporations have accepted that this is a key role. Moreover, that suggests that such a role is both practical, and can properly be described as 'best practice'.

Finally, it must be acknowledged that audit committees are not necessarily effective just because they have a charter (Krishnamoorthy *et al.*, 2002). Much may depend on the intelligence and diligence of participants—and perhaps their financial expertise and experience. However, having a clear idea about the objectives and potential responsibilities of audit committees is a good start.

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APPENDIX

A MODEL CHARTER FOR AN AUDIT COMMITTEE*

OBJECTIVES

- To ensure the integrity of external financial reporting.
- To safeguard the independence of the external auditor.
- To ensure that directors and senior management are provided with financial and non-financial information that is of high quality and relevant to the judgments to be made by them.
- To ensure that controls are established and maintained in order to safeguard the organization's financial and physical resources.
- To ensure that systems or procedures are in place so that the entity complies with relevant statutory and regulatory requirements.
- To assess financial risks arising from the entity's operations, and consider the adequacy of measures taken to moderate those risks.

MEMBERSHIP

- Members shall be appointed by the board for a limited period and shall not automatically be re-appointed.
- The majority of members shall have experience in financial reporting, or management reporting. However, membership shall reflect a mix of skills and experience. To that end, the board may engage outside experts to strengthen the audit committee (either as members or advisers).
- Executive directors shall not be members of the audit committee.
- The chair of the board shall not chair the audit committee.

* This model charter is intended for major listed corporations or other entities that invite public investment.

AUTHORITY

The committee shall make determinations about matters for which it is responsible; save where this charter limits the committee's authority to that of making recommendations to the board.

The committee shall be provided with secretarial and other services to enable it to perform its functions.

The committee has the authority to require members of management or others to attend meetings and to provide advice or information.

The committee has the authority to access the entity's documents and records.

The committee shall have access to legal or other specialist advice.

Members of the committee shall be entitled to training relating to issues specific to the industry in which the firm operates.

RESPONSIBILITIES

Generally

To ensure that members are informed about changes in statutory requirements, accounting standards, or guidelines affecting financial reporting.

To assess whether the resources devoted to the accounting function (including training and succession planning) are adequate to ensure that reporting arrangements are of high quality—and to advise the board of any identified shortcomings.

To ensure that periodic assessments are undertaken of the financial risks faced by the entity in the course of its operating activities, and to review and agree on the arrangements undertaken to manage or mitigate those risks.

To consider and review the adequacy of internal controls, having regard to risks.

To consider, periodically review, and approve schedules of delegated authorities operating within the organization.[†]

To provide a line of communication so that employees may raise issues of concern relating to the management of the organization's physical and financial resources, or to the accuracy or sufficiency of information being provided to managers or the board, or board subcommittees.

To provide a statement in the entity's annual report describing the audit committee's objectives and responsibilities, and how it has discharged those responsibilities during the past financial year.

Related Party Transactions and Executive Expenditure

To consider, and if thought appropriate, pre-approve any proposed related party transactions.

To review the adequacy of internal controls relating to executive travel and entertainment.

[†] The board may choose not to delegate the authority to undertake certain transactions, or to reject certain proposals (such as overtures relating to possible takeovers or mergers).

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Responsibilities in Relation to Independent External Audit

- To conduct audit tenders periodically, and recommend the appointment of an auditor.
- To propose to the board the terms of the contractual engagement with the auditor, over and above statutory requirements.
- To review the audit plan proposed by the auditor, and suggest potential improvements or changes in coverage.
- If considered appropriate, to pre-approve any arrangements for the provision of non-audit services that will not threaten the independence of the auditor.
- To review audit fees each year and the terms of the audit engagement.
- To seek the external auditor's assessment of the quality and coverage of internal audit work and of the competence of internal audit staff.
- To assess the performance of the external auditor on an annual basis, and to consider whether it is appropriate to propose to the board that an auditor be removed, or that competitive tenders for audit work be sought.

Responsibilities in Relation to Internal Reporting

- To consider the completeness and quality of financial and operational information being provided to the board, and to suggest ways in which those reports might be improved.
- To seek advice periodically from internal and external auditors regarding the completeness and quality of financial and operational information being provided to senior management and the board.
- To undertake post-investment reviews of major transactions or capital investments, with the aim of assessing the adequacy of the analysis undertaken before decisions were made to proceed with those transactions or investments, so that the organization can learn from those experiences and improve its analytical capabilities and reporting processes.

Responsibilities in Relation to Internal Audit

- To review and agree on the appointment, replacement, re-assignment or dismissal of the internal auditor.
- To review the organization and quality of internal audit staff.

Or, if the internal audit function is outsourced

- To review the terms of the engagement of the internal auditor.
- To conduct audit tenders periodically and recommend the appointment of a firm to undertake internal auditing.
- To review the performance of the contract internal auditor.
- To review with the internal auditor and the external auditor the coordination of audit efforts to ensure the efficient effective use of audit resources.

Responsibilities in Relation to External Reporting

- To review the statement of accounting policies and other notes in the draft accounts, and to gain an awareness of the areas in which management discretion in the choice of accounting methods has been exercised, to make determinations

in relation to the choice of accounting policies, and also to ensure that notes to the financial statements describing the choice and application of accounting policies are informative.

To review draft financial statements, prior to endorsement by the board for submission to shareholders for adoption.

To review half-yearly and other interim reports for compliance with regulatory requirements.

To review reporting arrangements to ensure that the firm meets its obligations to undertake continuous disclosure to the market and regulatory agencies.

Responsibilities in Relation to Risk Management

To review management's approach to the management of risks (including economic dependency, the adequacy of insurance arrangements, business continuity planning, and exposure to movements in exchange rates or interest rates).

To assess whether audit plans developed by the internal and external auditor are consistent with the financial and operating risks facing the organization.

Responsibilities in Relation to Compliance

To ensure that the procedures established to monitor compliance with statutory requirements, regulations, and contractual obligations are appropriate.

PROCEDURES

Attendance

All directors who are not members of the audit committee shall have the right to attend meetings of the committee.

The chief executive officer and the chief financial officer shall be invited to attend all meetings of the audit committee (*though not necessarily for all agenda items*).

The external auditor shall be invited to attend all meetings (*though not necessarily for all agenda items*).

The internal auditor shall be invited to attend meetings, as appropriate.

Meetings

The committee's secretary shall propose a schedule of audit committee meetings to ensure that all of the committee's responsibilities are addressed during the financial year, and to ensure that communications with internal and external auditors are maintained on a regular basis.

Normally the committee shall meet at least six times per annum.

Meetings may be called by the chair of the committee, or at the request of the chair of the board.

Secretarial Services and Minutes

The board shall appoint an executive to act as secretary to the committee. The secretary shall (in conjunction with the chair) be responsible for:

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- drawing up the agenda, supported by documentation, and circulating that material to committee members prior to each meeting;
- preparing draft minutes of the meetings of the audit committee, and circulating minutes to members of the committee and the board; and
- maintaining registers.

Reports from the internal auditor and the external auditor shall be provided to members prior to the meeting.

The secretary shall provide draft minutes of meetings and provide them for review by the chair of the audit committee within ten working days.

Minutes shall be accompanied by an 'action plan' detailing matters that require attention as the result of the committee's deliberations.

Copies of minutes of audit committee meetings shall be provided to the board at its next meeting after those draft minutes have been reviewed by the chair of the committee.

Reporting Relationships With the External Auditor

The external auditor normally shall communicate directly with the audit committee, while recognizing that in certain situations the auditors may wish to communicate with the board or other subcommittees of the board.

The chair of the audit committee shall be provided with draft management letters or other reports at the same time as they are provided to management (but shall, except in exceptional circumstances, not pursue enquiries until management have had an opportunity to respond to the draft report).

The chair of the committee shall provide opportunities for the external auditor to meet with the committee without executive directors or other management representatives present.

Reporting Relationships With the Internal Auditor

The audit committee is the 'client' of the internal auditor (save where the committee has agreed with management that certain projects be undertaken for the assistance of management). As such, final reports shall be addressed to the committee.

The chair of the audit committee shall be provided with draft reports from the internal auditor at the same time as management (but shall, except in exceptional circumstances, not pursue enquiries until management has had an opportunity to respond to the draft report).

The chair of the audit committee shall provide opportunities for the internal auditor to meet with the committee without executive directors or other management representatives present.

Reporting to the Board

The board of directors shall be provided with minutes of audit committee meetings (and oral reports of any meetings held subsequent to the last board meeting for which minutes have yet to be prepared)—such minutes or reports to describe major actions undertaken by the committee or any recommendations to management or the board.

Confidential Communications From Employees

Employees shall be advised that under certain limited circumstances they may communicate to the chair of the audit committee, regarding potential fraud or misappropriation, weaknesses in internal controls, or the adequacy or accuracy of information being provided within the organization to senior managers or the board. Contact numbers or email addresses shall be provided to employees for this purpose. Such communications (which shall be in writing) shall be treated as confidential. They should explain whether the matters have previously been discussed with an employee's manager, and if not, why the employee has chosen to report to the audit committee.

Maintenance of Registers

The secretary of the committee shall maintain a register of recommendations made by the external and internal auditors. The register shall record a summary of management responses to those recommendations, and whether the recommendations were adopted, implemented, or rejected.

The secretary shall provide the committee at each meeting a summary of the register, highlighting management responses to recent recommendations and any recommendations that have yet to be resolved.

The chair of the audit committee shall maintain a register of employee confidential communications, and how they were dealt with.

Review of Delegations

Schedules of delegations are to be reviewed at least annually, or whenever there are major changes in the management structure of the firm.

Review of Committee Performance

The committee shall review its performance annually, with particular attention being paid to the extent to which it has met its responsibilities in terms of this charter.

Publication and review of the Charter

The charter shall either be published in the annual report, or made available on the entity's web site.

The charter shall be reviewed and updated annually, initially by the audit committee and then by the board.

JASON ZEZHONG XIAO, PAULINE WEETMAN AND MANLI SUN

Political Influence and Coexistence of a Uniform Accounting System and Accounting Standards: Recent Developments in China

This article investigates the role of political influence, as well as accounting tradition and the equity market, in China's recent changes in accounting regulation. We find that the Chinese government, in part self-motivated and in part under external pressure, has been active in developing accounting standards in harmony with international accounting standards. However, it has retained a uniform accounting system in the Enterprise Accounting System issued in 2000 to accommodate the special circumstances of a transforming government, strong state-ownership, a weak accounting profession, a weak and imperfect equity market, and the inertial effect of accounting tradition and cultural factors. This article also contributes to existing models of accounting system classification by illustrating the need for considering political influence as a factor that affects the rate of transition towards full implementation of international accounting standards.

Key words: Accounting; China; International; Standards; Uniform accounting system.

In their analysis of the effect of institutional factors on properties of accounting earnings, Ball *et al.* (2000) choose the political system as the key discriminating factor. This differs from Nobes (1998), who argues that the relative strength of the equity market and the degree of cultural dominance (in terms of colonial inheritance and invasion) are sufficient to discriminate between types of accounting system. These two factors capture all the detailed factors contained in previous theoretical and empirical articles on classification. However, Nobes also acknowledges that the nature of the political system might well be relevant to a broader study.

China is a country where the economic developments of recent years have been accompanied by significant changes in political attitude, but within a framework of continuing strong governmental control. Consequently we explore the influence of

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political factors, especially government involvement, on China's accounting regulation. Specifically, we analyse the role of the Chinese government in revitalizing a prescriptive uniform accounting system (UAS) while developing a set of professionally oriented accounting standards.

In illustrating the propositions of his general theory, Nobes (1998) takes the example of China as 'a country without a strong equity-outsider tradition, but which seems to be moving towards such a system. Class A accounting¹ is followed' (p. 169, citing Chow *et al.*, 1995; see also p. 180, citing Davidson *et al.*, 1995). Nobes qualifies this description as relating to large or listed companies, reflecting an impression that the population and the government 'seem keen on moving to an equity-outsider system'. He also suggests that inertial factors may retard changes in the accounting system. Thus, in addition to political influence, the role of the equity market and the inertial effect of accounting tradition in accounting regulation are examined. The impact of inertial factors on accounting regulation is investigated because, although external cultural dominance as envisaged by Nobes explains the initial import of a UAS from Russia to China in the 1950s, it does not explain why a UAS persists in China's recent market-oriented economic reform. In addition, the imported UAS has been so internalized that it has become regarded as a Chinese national tradition (Li, 2001). A major reason for adapting Nobes' framework in this article is that we perceive that his classification of Class A and Class B accounting systems may be dependent on whether a country adopts UAS or accounting standards.²

This article demonstrates that the development of accounting systems in China shows continuing evolution of the complex contradictions evidenced in Aiken and Lu (1998). Their analysis, and those of Tang and Dunk (1999) and Chen *et al.* (2002), are extended by reference to recent developments in accounting regulation in China. Although accounting regulation has been examined in several prior academic studies (e.g., Xiang, 1998; Chen *et al.*, 2002), no study has specifically analysed and theorized issues relating to the coexistence of accounting standards and a UAS in China. This study also advances knowledge by offering an extension of Nobes' model to situations where accounting developments are inextricably entwined with political change. The study provides insight into the unique dynamics, issues and problems encountered by regulators in a transition economy who are incorporating international accounting standards (IAS) into accounting regulations. Such insights facilitate understanding of the problems of achieving international accounting harmonization. The fact that China is not alone in attempting to integrate IAS-type accounting standards with a UAS suggests that our study should inform international accounting standard setters and accounting regulators facing issues similar to those in China.

¹ Class A accounting, in Nobes (1998), is an accounting system closer to the Anglo-Saxon focus on accounting for external shareholders, as opposed to Class B which is an accounting system closer to the continental European focus on accounting for tax and creditors.

² Here we treat Nobes' Class A and Class B as labels for extreme cases rather than hard categories.

For this article the term uniform accounting system is used to designate an accounting system of basic rules for recording, recognition and measurement that include a chart of accounts. In 2000 the Chinese Ministry of Finance introduced a new UAS called the Enterprise Accounting System, effective from 1 January 2001. This complements China's work to develop accounting standards in harmony with IAS. The new UAS was rather controversial and intensified the long-standing debate among Chinese regulators and academics as to whether to continue to adopt a UAS, develop accounting standards, or allow both to coexist (see below). The Enterprise Accounting System combines a basic conceptual framework with a chart of accounts and detailed bookkeeping procedures. On the surface this appears to be a reversal of China's accounting reforms that could inhibit China's move towards the full implementation of IAS in the manner implied by Nobes' (1998) Class A system.

This prompts us to ask the following research questions:

- Why does it appear necessary for some countries to retain or adopt a UAS while implementing IAS, whereas other countries do not apparently need to regulate the recording system?
- More specifically, why does China maintain and reinforce a UAS while developing accounting standards that reflect IAS?
- How may the emerging accounting system in China be related to Nobes' general model?

To address these questions, we develop a two-dimensional theoretical framework. The first dimension consists of three factors that have been proposed as providing high-level explanations of differences among accounting systems. These comprise the degree of government involvement in accounting regulation, prompted by Ball *et al.* (2000), together with the strength of the equity market and the inertial effects of accounting tradition, drawn from Nobes (1998). The second dimension of our framework represents the impact of these factors on the demand for, and supply of, UAS and accounting standards of the IAS type. We use this framework as a guide in explaining the coexistence of a UAS alongside IAS-type accounting standards in China.

We hypothesize that political influence, the nature of the equity market, and the inertial effect of accounting tradition together shape the accounting system in China, as well as in other transition economies. The Chinese government is shown to be in part self-motivated and in part driven by external pressures, and to have been promoting accounting standards that harmonize with IASs. The rapidly growing equity market has provided momentum for setting accounting standards in China, but is still weak and imperfect and thus generates a relatively weak demand for, and constrains the supply of, accounting standards. The accounting tradition of relying on a UAS, initially derived from an external influence relating to political change, has become part of the accounting subculture to the extent that the Chinese government has taken steps to incorporate elements of IAS into the Enterprise Accounting System.

Our analysis is based on contemporary opinion published in China and also draws on interviews with key participants in the process of change. These are

regulators (A to E), academics (A to C) and an auditor (A).³ Our selection of the interviewees was primarily based on each interviewee's relatively close involvement with accounting regulation. This selection criterion did not allow us to draw a large sample of interviewees. However, we believe that the well-informed nature of each of our interviewees gave insight that was more informative than taking the views of a larger number of persons with little or no involvement in accounting regulation. Some interviews were undertaken shortly before, and some immediately after, the Enterprise Accounting System was issued, with open-ended questions suited to each interviewee's background.

The main questions that were asked in the interviews relate to major changes in accounting regulation between the 1950s and the 1990s (with appropriate variation to take account of the experience of younger interviewees). We asked for opinions on the reasons for these changes, the causes and processes of setting accounting standards, and the reasons why China retains a UAS while at the same time evolving IAS-type accounting standards. One interview was conducted on the telephone and lasted for just over twenty minutes, while face-to-face interviews were undertaken by one of the authors with an assistant, each lasting for approximately two hours. The main purpose of the interviews was to obtain an insider's view on why a UAS and accounting standards coexist, rather than to develop an exact measure of the support for (or opposition to) such a dual-track development.⁴

DISTINGUISHING FEATURES OF UAS AND ACCOUNTING STANDARDS

Table 1 summarizes the differences between the standards-based approach and the UAS approach to regulation of accounting.

To achieve uniformity, a UAS typically consists of a chart of accounts and rigid formats of financial statements applicable to all business entities in an industry or across all industries (see Roberts and Salter, 1999, for a review of studies on accounting uniformity). To provide guidance, a UAS also normally explains how the accounts are applied to typical economic transactions and how the financial

³ Regulators A to E are all divisional or sub-divisional directors or deputy directors from the Ministry of Finance and the China Securities Regulatory Commission. Regulator A was heavily involved in exploring the possibility of adopting accounting standards in China in the 1980s and became an accounting regulator in the mid-1990s. Regulators B and C were accounting regulators from the 1960s to the mid-1990s, whereas Regulators D and E were accounting regulators from the 1980s to 2002. Academics A and C are internationally known university accounting professors. They have been closely involved with accounting standard setting in China and were officially appointed advisors to accounting standard setters. Academic B is also a leading accounting professor maintaining close contact with the accounting regulators at the Ministry of Finance since the 1980s and has provided research assistance to the accounting regulators. Auditor A is a senior partner of one of the largest Chinese accounting firms and was an independent auditing standard setter. Due to the politically sensitive nature of the interviews, the anonymity of the interviewees is preserved.

⁴ Indeed, there was a huge gulf between accounting regulators and academics on whether China should concentrate on developing more and better accounting standards or maintain both a UAS and accounting standards, as is shown by the discussion of the controversies caused by the Enterprise Accounting System below. Despite this divide, China issued this UAS.

TABLE 1
A CONTRAST BETWEEN A UNIFORM ACCOUNTING SYSTEM AND ACCOUNTING STANDARDS

Features	Standards-based approach (IAS-type)	Uniform accounting system (UAS)	Possibility of coexistence of IAS and UAS
Technical			
Chart of accounts	Not used	Typical	Supplement UAS with IAS
Focus of regulation	No focus on basic recording and measurement, strong focus on disclosure for investors	Includes rules or strong guidance on recording and basic measurement, less focus on disclosure for investors	Extend IAS to cover recording, or extend UAS to cover disclosure
Coverage	Focus on a single topic	Broad coverage of many types of transaction	Supplement UAS with IAS
Conceptual			
Conceptual framework	Explicit	None, or implicit but unstated	Develop UAS on the basis of an explicit conceptual framework
Form of regulation	Principles set the framework for rules and guidance	Dominance of rules and guidance, principles taking a supplementary role	More guidelines to supplement IAS and develop UAS on the basis of a conceptual framework
Scope for professional judgment	Strong	Limited	Increase scope for professional judgment in UAS
Orientation			
User focus	Investor-oriented	Government-oriented	Increase user orientation in UAS
Main function	Information provision	Control	Increase information provision function in UAS
Relation between accounting and taxation	Financial accounting separate from tax accounting	Financial accounting determined by tax and fiscal regulations	Detach UAS from tax rules
Evolution	Bottom-up: developed out of best practices	Top-down: developed out of political and administrative requirements	
Example			
Systems	Australia, Canada, U.K., U.S., IAS	China, France, former Soviet Union	

statements are prepared. In contrast, accounting standards, including IAS, do not prescribe such a chart of accounts and rigid formats of financial statements. The UAS focuses on recording, recognition and measurement of transactions whereas accounting standards focus on recognition, measurement and disclosure. Each IAS-type accounting standard typically deals with one type of transaction or one accounting issue, and as such can explore a topic more comprehensively. In contrast, a UAS deals with a wide range of transactions and thus usually only provides descriptions of accounts and their application without conceptual grounding.

Accounting standards usually contain concepts and principles to guide professional application of accounting methods, whereas a UAS contains more specific instructions. Consequently while the implementation of accounting standards arguably requires strong professional judgment, the scope of professional judgment is more restricted in a UAS. It could be argued that the nature of IAS is changing towards detailed rules (such as the detail of IAS 39 on financial instruments) but these are rules for complex accounting measurement and disclosure in the context of implementing the standard. In contrast, a UAS contains basic principles and rules of accounting records and measurement. The 'principles versus rules' debate within the U.S. Financial Accounting Standards Board (FASB, 2002) relates to advanced rules of implementation utilizing the 'fair' presentation principle in specific cases (Schipper, 2003) rather than general rules of recording and measurement.

In orientation, IAS-type accounting standards are intended to provide information useful for investors and other users while a UAS is typically designed as a tool for administrative control (Choi and Mueller, 1978). Accordingly, while 'fair presentation' is a strong principle underscoring the development of IAS, the main driver for stipulating a UAS is the provision of an effective mechanism of administrative control. In addition, IAS-type accounting standards have mainly evolved from best practice at the microeconomic level of individual companies, whereas a UAS is usually developed to meet the requirements of political and macroeconomic control. Consequently, accounting standards in many cases are detached from tax and fiscal regulations whereas many aspects of a UAS are determined by fiscal policies.

It is possible for accounting standards and a UAS to coexist. One option is to allow companies to adopt accounting standards of IAS type for preparing group accounts while the UAS drives individual accounts (as in France).⁵ A second option is to supplement accounting standards with a chart of accounts (as in Romania, see King *et al.*, 2001). The approach taken in China has been to supplement a UAS with IAS and to adopt IAS-defined methods within a UAS. Table 1 indicates other possible types of coexistence.

The question remains as to why accounting standards and a UAS-type approach coexist in some countries, whereas a UAS is not needed in other countries. Following Ball *et al.* (2000) and Nobes (1998), we identify three variables that may

⁵ The Second Methodology, obligatory for groups after 1 January 2000, allows listed companies to use international standards translated into French, under conditions stipulated by the Comité de la Réglementation Comptable (CRC). This does not set large groups totally free from French legislation but does allow multinational groups to choose more international methods (Ordelleide and KPMG, 2001, pp. 1135–6, 1144).

indicate this coexistence: the extent of political involvement in accounting regulation, the relative strength of the equity market, and the inertial effect of accounting tradition. We suggest that where government involvement in accounting regulation is strong, the equity market is relatively weak, and an accounting tradition of reliance on a UAS exists, the UAS persists even where the government relaxes control to allow an independent regulatory body to emerge. It is further suggested that the combined impact of these variables is manifest in the relative demand for, and supply of, UAS and IAS-type accounting standards. Table 2 presents our analysis of the relation between these variables and the demand for, and supply of, UAS alongside accounting standards.

Illustration of the Framework

Nobes (1998) classifies accounting systems into Class A (e.g., those of Australia, the U.S. and the U.K. and also the IASB standards⁶) and Class B (e.g., those of France, Germany and Italy) characterized by specific accounting features. Nobes indicates that his characterization of Class A and Class B accounting systems is a preliminary suggestion. We suggest that an additional distinguishing feature is that Class A systems are regulated through accounting standards set by independent standard setting bodies while Class B systems encompass more detailed guidance on bookkeeping and accounting processes. In some cases this involves legislation for a chart of accounts; in other cases authoritative sources provide guidance in a form similar to a chart of accounts.

To illustrate the framework outlined in Table 2, we consider the countries sampled by Ball *et al.* (2000) and Jaggi and Low (2000)—Australia, Canada, U.S.A., U.K., France, Germany, and Japan—and add a group of Eastern European countries which resemble China in moving from central planning to a market-based economy. Table 3 sets out, for each country, our three explanatory variables.

We analyse political influence in terms of the extent to which government takes a direct role in accounting regulation, rather than by using a proxy. This approach takes us to the heart of the political influence that we seek to evaluate in the case of China. It is also more sensitive to changes in the political influence on accounting. Government involvement is categorized as 'high' or 'low' on the basis of the specific nature of government involvement in accounting regulation.

The relative importance of the equity market is measured using the ratio of market capitalization to gross domestic product (Nobes, 1998) and the percentage of ownership by the three largest shareholders in the ten largest domestic companies (La Porta *et al.*, 1998).

Table 3 shows that it is more likely that accounting standards are adopted without UAS-type regulation of the recording system where there is relatively weak governmental (but strong professional) involvement in accounting regulation, a strong equity market with wide dispersion of shareholders, and no accounting tradition of using a UAS. In contrast, the adoption of accounting standards is

⁶ We refer to the IASB standards as IAS (international accounting standards) because no international financial reporting standards (IFRS) had been issued at the period of this study.

TABLE 2
RELATIVE DEMAND FOR, AND SUPPLY OF, UAS AND IAS

	Factors making demand for UAS stronger than demand for IAS	Factors making supply of UAS stronger than supply of IAS	Factors making demand for IAS stronger than demand for UAS	Factors making supply of IAS stronger than supply of UAS
Government involvement				
High level, direct	UAS is needed to support macroeconomic control	Government, as the primary source of accounting regulations, tends to issue detailed rules; weak accounting profession with little involvement in accounting regulation		
Low level, indirect or absent			Little demand for UAS as regulators have few macroeconomic concerns and government does not directly manage business firms	Strong profession prefers self-regulation and resists government involvement
Equity market				
Weak or absent	Less sophisticated transactions require less professional judgment; less developed market requires more central planning; market conditions not conducive to accounting standards; firms have less autonomy	Regulators have little/no experience in developing accounting standards		

Strong	Firms require more autonomy; market forces require sophisticated information on investment opportunities and risks; sophisticated market transactions require more professional judgment	Standard setters are experienced in investor-oriented standard setting; market imposes fewer technical constraints on standard setting
Accounting tradition of reliance on a UAS		
Yes	Evolved an infrastructure suited for UAS; inertial resistance to accounting standards that involve substantial judgment	Regulators at some point in the past found UAS useful to their needs; regulators are experienced in developing UAS
No		Regulators are experienced in developing accounting standards; regulators have not found a UAS useful
Role of UAS in implementing IAS	UAS used to support IAS	Evolved an infrastructure that is suited for accounting standards
		UAS not needed to implement IAS

TABLE 3
IMPACT OF GOVERNMENT INVOLVEMENT, EQUITY MARKET AND ACCOUNTING TRADITION*

Country	Current accounting regulation ^b	Political influence		Equity market			UAS tradition
		Accounting regulator	Level of government involvement ^c	Market capitalization ^c to GDP ^d	Ownership structure (median) ^e	Strength of equity market	
Australia	No UAS	Australian Accounting Standards Board (AASB)	Low	0.84	0.28	Strong	No
Canada	No UAS	Canadian Institute of Chartered Accountants (CICA)	Low	0.99	0.24	Strong	No
U.K.	No UAS	Accounting Standards Board (ASB)	Low	1.92	0.15	Strong	No
U.S.A.	No UAS	Financial Accounting Standards Board (FASB)	Low ^f	1.16	0.12	Strong	No
Japan	No UAS	Accounting Standards Board of Japan (for new standards from 2001), previously Business Accounting Deliberation Council (BADC), advisory to the Ministry of Finance	High, cautiously moving lower from 2001	1.01	0.13	Strong	No
France	UAS ^g	Conseil National de la Comptabilité (CNC); Comité de la Réglementation Comptable (CRC)	High	1.00	0.24	Strengthening	Yes

Germany	Elements of UAS	Ministry of Finance sets law (HGB) and gives approval to standards prepared by the Deutsches Rechnungslegungs Standards Committee (DRSC)	High	0.66	0.50	Strengthening	Yes
Czech Republic	UAS	Ministry of Finance	High	0.07	n.a.	Weak	Yes
Hungary	UAS	National Accounting Committee	High	0.10	n.a.	Weak	Yes
Poland	UAS	Accounting Act sets regulations; influence of IAS is seen	High	0.10	n.a.	Weak	Yes
Romania	UAS	Ministry of Finance	High	0.00	n.a.	Weak	Yes

* More details are available from the first-named author if required.

^b Based on Ordelheide and KPMG (2001): No UAS = Design of the recording system is left to discretion of individual companies; UAS = Regulation incorporates a chart of accounts.

^c World Federation of Exchanges (FIBV, 2001).

^d CIA (2001).

^e Ownership concentration: La Porta *et al.* (1998).

^f Strong equity-outsider is based on market capitalization / GDP > 0.5 and ownership less than 0.30, whereas weak equity-outsider is based on not meeting one or both of these conditions.

^g With regard to the 'rules versus principles' debate in the U.S., following on from the Sarbanes-Oxley Act of 2002, it is argued by Schipper (2003) that the FASB standards are based on the principles of the FASB Concepts Statements, but the demand for guidance on the principles has led to the present proliferation of rules expanding on the principles. That kind of guidance is specific to the relevant accounting standard and is at a higher level than the guidance typically found in a UAS.

^h There is no formal plan as in France, but principles of proper bookkeeping (GoB) (in the sense of explanatory accounting rules) are required by legislation (HGB) (Ordelheide and KPMG, 2001, p. 1244). The voluntary accounts frameworks (charts of accounts) that have been developed for specific industries (Ordelheide and KPMG, 2001, p. 1253) may be seen as an extension of former regulation (existing prior to the 1940s).

superimposed on a UAS, either by regulation or by custom, where there is strong government involvement in accounting regulation, a weak equity market with a narrow base of shareholding, and a tradition of adopting a UAS.

It may also be seen from Table 3 that the three explanatory variables appear closely related. It is perhaps not surprising that, in a stable political system, a government which encourages a stock market to develop also allows market forces to influence the development of accounting standards. (Enforcement of accounting standards for efficient operation of a market may require government involvement. However, this article focuses on the process of determining the rules, rather than the process of enforcement.) As the stock market develops, a strong accounting profession grows with increasing expertise in basic principles and practices of recording transactions. In contrast, a government which sees control of the business environment as an important factor in macroeconomic policy is less concerned with developing equity funding of business and has greater motivation for detailed regulation of all aspects of accounting practice. Moreover, strong government involvement, a weak capital market and a weak accounting profession reinforce a tradition of reliance on a UAS.

It may be that, in some situations, one of the three factors is sufficient to discriminate between accounting systems. However, when combined, the three variables appear to offer stronger explanations. For example, although Japan is similar to France and Germany in terms of a high level of government involvement in accounting regulation, Germany and France have a tradition of using UAS while Japan does not have that tradition. The comparison between Japan and Germany or France shows that government involvement alone is an insufficient condition for a country to adopt a UAS. Thus, even though government involvement in accounting regulation may be increasing in the U.S. as a result of major recent corporate scandals, the strength of the equity market and the strong tradition of professionalism make it unlikely that a UAS would be proposed in the U.S. Accordingly we treat the three variables as joint forces that help us explain a country's accounting regulatory choices. In particular, we investigate how the three factors and changes in these factors have caused China to use a UAS in parallel with accounting standards.⁷

DEVELOPMENT OF ACCOUNTING REGULATION IN CHINA

This section traces key stages of evolution in accounting regulation in China since 1949 and outlines the new Enterprise Accounting System.

Historical Developments

In the early 1950s a UAS was imported from the Soviet Union to support a central planning system. Capitalist accounting systems of the previous Nationalist

⁷ Table 3 provides a cross-sectional analysis that allows us to discuss the patterns of association of our three key factors with different types of accounting system. We use this analysis to show that the relative impact of these three factors may explain the state of the accounting system in China, and in particular the friction that may currently inhibit the process of change. However, there is also an interaction of the factors in Table 3 over time and we use the same ones to explain the historical development of accounting in China leading to the present position.

regime and of Western countries were firmly rejected (Xin and Huang, 1951). The UAS was eradicated during the mass movement of the Great Leap Forward in 1958, which ran into economic and political disarray. Partial economic recovery from 1962 to 1965 was followed by ten years of the Cultural Revolution, during which China fell even further behind its capitalist competitors (Expert Group, 1995). Accounting education ceased during the Cultural Revolution (Yan and Wang, 2000).

Policies of economic reform and 'open door' were established at the Chinese Communist Party's Third Plenum of the Eleventh National Congress (CPC Central Committee, 1978) but without a clear objective for reform and an idea of how to implement these policies. With a shift in focus from class struggle to economic development (CPC Central Committee, 1978), the Ministry of Finance regained control of accounting regulation and restored the industry-based UASs of the earlier period for three reasons. First, the UASs were regarded as very effective (Xiang, 1999). Second, China's approach to reform was one of experimentalism and gradualism (Expert Group, 1995) and restoration was an obvious choice. Finally, China still operated a central planning system.

As new forms of business (such as Sino-foreign joint ventures and joint-stock companies) emerged, further industry-specific or ownership-specific UASs were created. The Sino-foreign joint ventures created a need for international accounting harmonization (Xiang, 1998). This prompted the Ministry of Finance to issue the *Accounting System for Sino-Foreign Joint Ventures* in 1985 and led the Accounting Society of China and the Ministry of Finance each to establish a project group for studying accounting standards in 1988.

The Tiananmen Student Movement of 1989 reinforced the ongoing ideological debate over the direction of economic reform. The question was whether China should adopt a market economy; this was regarded by conservative opinion as a capitalist development. Despite ideological resistance, China established the Shanghai and Shenzhen Stock Exchanges in 1991, driven by a desire to transform state-owned enterprises and the function of government. In 1992, Deng Xiaoping (Deng, 1992), regarded as the 'Chief Architect' of China's economic reform, openly called for the development of a socialist market economy. That action concluded the ideological debate between those who called for reform and those conservatives who questioned the nature of reform (Ma and Ning, 1998). This subsequently became the official objective of China's economic reform. Amid this climate, the Ministry of Finance issued *Accounting System for Companies Experimenting with a Shareholding System* and the *Accounting Standard for Business Enterprises* (ASBE) in 1992 (Ministry of Finance, 1992). Beginning in 1993, the Ministry of Finance completed a three-year standard setting project sponsored by the World Bank, resulting in exposure drafts of thirty-two detailed standards (Xiang, 1998).

The ASBE provided a set of standards but did not give sufficient guidance on the application of permitted accounting methods. It was recognized that the government would need more time to promulgate all the detailed standards, and hence separate industry-based UASs were developed to implement the ASBE.

Although listed companies have been required to adopt either the existing Chinese accounting standards or IAS, they have also been required to adopt various UASs where accounting standards are lacking.

The Enterprise Accounting System

The introduction of the Enterprise Accounting System is part of a continuous regulatory response to 'an accounting information crisis' (Li, 2001). Extensive false reporting and earnings management by companies have discredited accounting information and hampered the development of the capital market. To tackle this issue, the Accounting Law was amended in 1999 to stress the importance of 'true and complete' accounting information. In 2000, the State Council issued an Enterprise Financial Reporting Regulation, redefining the elements of financial statements in line with the conceptual framework of the IASC and stipulating responsibilities and liabilities for parties involved in accounting, auditing and reporting. The revised definitions aim to reduce the scope for manipulation that can take place under the looser definitions provided in the ASBE. These definitions are elaborated in the Enterprise Accounting System. Although industry-specific UASs had been stipulated to enable a smooth adoption of the ASBE, the growing complexity of business organizations and diversification have made it difficult for companies to select the appropriate UAS. Thus Li (2001), then Assistant (now Deputy) Minister of Finance, expects the Enterprise Accounting System to enhance the comparability of information.

The Enterprise Accounting System has three parts (see Appendix for details). Part 1 defines basic concepts, elements of financial statements, recognition and measurement principles, permissible accounting methods, structures and content of the main financial statements. Part 2 prescribes a chart of accounts and financial statements. Part 3 exemplifies accounting treatments of the main elements of financial statements. The first part replaces the ASBE and brings in several new features:

- An expanded application of the prudence principle that was first prescribed in ASBE,⁸ by requiring provisions for impairment of eight types of asset⁹;
- Increased freedom in allowing companies to determine the rates of provision for asset impairment;
- A new accounting principle: substance over form;
- New requirements relating to segmental reporting; and

⁸ The principle of conservatism, or prudence, was banned until very recently because it was regarded as a tool of capitalist exploitation (Regulator D). The perception of prudence or conservatism in China as a tool of capitalist exploitation was rooted in Maoist class struggle ideology and reinforced by numerous mass class struggle movements in China between the 1950s and the 1980s. Specifically, prudence was seen as a source of distortion and manipulation in the interest of capitalists. For example, Xin and Huang (1951), two leading pro-Soviet accounting professors, cite conservatism as an example of hypocrisy and bias against working classes in capitalist accounting. As a result, this concept was not used in accounting regulation until 1992, when the Accounting System for Business Enterprise (ASBE) included it as a basic principle.

⁹ Provision for asset impairment is widely seen as an application of conservatism in China (see, e.g., Liu, 2001a).

- Reduced orientation towards the government, as government is no longer emphasized as the most important user group.

The Enterprise Accounting System is intended for all industries and firms with different ownership structures and for both group and individual companies.¹⁰ Consequently the Enterprise Accounting System should help achieve uniformity, although further specific guidance will be developed for certain industries.

The Enterprise Accounting System is controversial. Some people have argued that the effort should be devoted to developing better accounting standards because UAS are a product of the planned economic system (Academic A; Liu, 2001c). Others have suggested that the Enterprise Accounting System achieves the desired purpose of harmonizing Chinese accounting regulation with IAS although it adopts the form of a UAS in order to suit the needs of Chinese accountants and auditors (Liu, 2001c). Regulator A, however, responded that if it is the form that makes it different, perhaps the form should be dropped.

FACTORS SUPPORTING COEXISTENCE OF ACCOUNTING STANDARDS AND UAS IN CHINA

We now draw on evidence from published comments and interviews to examine how government influence, equity market development and the inertial effect of the accounting tradition jointly determine China's dual accounting development in renewing a UAS while issuing IAS-based accounting standards.

Government Influence

Direct government involvement in accounting regulation in China is a political tradition that originated in the era of central planning. The reasons for persistent direct government involvement during the process of moving to a market economy are explored here. We also consider how direct government involvement relates to the parallel development of accounting standards and a UAS.

The continuation of direct government involvement in accounting regulation is seen in the Chinese Accounting Standards Committee (CASC), established in 1998 as a consultative body largely controlled by the Ministry of Finance (Academic A). One reason for (and perhaps also a consequence of) direct government involvement is that the accounting profession is politically weak. Although in the 1980s it emerged from virtual extinction (Xiao *et al.*, 2000), rapid growth in numbers has not been matched by improvement in quality and independence (Xiang, 1998). The professional body of auditors, the Chinese Institute of Certified Public Accountants, is under the control of the Ministry of Finance, which also issues auditing standards. Against this background, Regulator B considered direct government involvement as the only option. This is reflected in the following remarks he made when he recalled the debate at the end of the 1980s over who should set accounting standards:

¹⁰ The group company and its constituting enterprises are required to adopt consistent accounting policies for external reporting in China.

who should set them? Government or the private sector? Academics advocated a private standard setting body. But ask whether government will recognize accounting standards issued by a private body? If they are not acceptable by the government, what use will they have? ... even the private sector would not accept accounting standards issued by a private body.

The persistence of direct government involvement also reflects the continued dominance of state ownership (Feng, 2001). This is seen in majority government shareholding of listed companies,¹¹ and in the activities of the State-Assets Management Bureau and other government departments such as the Ministry of Finance in managing state-owned assets. Within individual shareholding companies (including listed companies), the government remains an important influence on corporate governance by way of personnel control and resource allocation. For non-shareholding enterprises owned by the state, the government not only controls senior management but also appoints a supervisory board to exercise financial monitoring and protect state assets and interests (State Council of China, 2000). Consequently the government is regarded as the main user of accounting information (Ministry of Finance, 1992). This is reflected in a remark that 'State ownership is the main ownership. This determines that the state is the main object that accounting must serve and is the main user of accounting information' made by Feng (2001, p. 7), then Director of the Department of Accounting Affairs Management and subsequently Assistant Minister of Finance.

The origins of the Chinese government's interest in accounting standards are found in both internal needs and external pressures. Internally, the Accounting Standards Project Group (1989) at the Ministry of Finance, which developed the ASBE in 1992, perceived accounting standards to be less detailed and more conceptual than UASs and saw that the Chinese UAS was inconsistent with prevailing international accounting conventions. Accounting standards were thus intended as a means of reducing government intervention into business affairs and implementing its open door policy.

There were also external pressures for international accounting harmonization. Zhang (1992), then Deputy Minister of Finance, acknowledged the complaint of foreign investors that they could not understand Chinese financial statements. The *Accounting System for Sino-Foreign Joint Ventures* (1985) thus incorporated internationally prevailing concepts and conventions (Regulator C) and these concepts and conventions were also reflected in the ASBE (1992). The Sino-foreign joint ventures also led directly to the creation of auditing firms (Xiao *et al.*, 2000). In addition, the World Bank and the International Monetary Fund pressed China to make its reporting understandable. These pressures were heard by the leaders of the Communist Party and the government, who in turn pressed the Ministry of Finance to find a solution (Regulator D and Regulator E). The result was the promulgation of the ASBE (1992) and subsequent accounting standards by the Ministry of Finance.

¹¹ For example, state ownership is present in over 90 per cent of listed companies (Sun *et al.*, 2002).

However, why has the government not discarded the UAS and just focused on developing accounting standards? Regulator E pointed to incomplete economic reform:

Even now, a firm's operating and management mechanisms have not been totally transformed and thus there is still a lack of demand for accounting standards... Our accounting standards are mainly applicable to listed companies. Why do we need a UAS? Because the reform of state-owned enterprises has not reached the stage where only accounting standards are required.

Several other direct factors can also be said to underpin the retention of the UAS. First, Chinese accounting regulators and academics see the UAS and accounting standards as complementary. Regulators (e.g., Zhang, 1992; Liu, 2001b) argue that industry-specific UASs should be developed based on the principles of general accounting standards. Ge (2001), a leading academic who once had an official advisory role in accounting standard setting in China, expresses the view that accounting reform should follow a 'substance over form' principle where the substance asks whether the accounting norms help provide reliable accounting information, help users read, understand and apply financial statements, and help regulators enforce monitoring. Feng (2001), a key regulator, stresses that the practical outcome of the accounting system matters more than whether the treatment is prescribed in accounting standards or in a UAS. Second, the government also seems to have underestimated the difficulty of setting and enforcing accounting standards. Commenting on why the Ministry of Finance was still committed to developing the Enterprise Accounting System, Regulator E said: 'One reason is that we have been unable to develop all the standards needed'.

In addition, macroeconomic concerns reinforce the adoption of a UAS. For example, the finance departments of the Ministry of Finance feared that the adoption of the prudence principle and manufacturing costing in the ASBE would undermine government revenues. Regulator D explained that it was painstaking to demonstrate to these departments that the ASBE would not affect government revenues or taxation in the long run. However, the adoption of a UAS could be resisted for the same macroeconomic reasons. Thus, when asked why the Enterprise Accounting System is only applicable to joint stock companies (including listed companies), Academic B remarked: 'The main reason is that the Enterprise Accounting System is so conservative that a broadened scope of application would "create" more loss-making companies. Nobody in China can bear this additional loss.'

Furthermore, the government has considerably more experience and expertise in designing and enforcing a UAS than it has in setting and implementing accounting standards. It may be more convenient and effective for the government to resort to a UAS rather than develop or amend accounting standards when new regulation is required. Although several reasons have been identified for the government's continued adoption of a UAS, it is interesting to consider whether a private body would have retained the form of a UAS. Academic B responded: 'The private body would still have to consider different needs and adopt different forms of regulation'.

We conclude from this analysis that in China the government continues to act as the accounting regulator in order to retain political control. It issues IAS-based accounting standards mainly to meet external pressures but retains a UAS-based approach in parallel as a means of detailed regulatory control. The UAS has the benefit of familiarity, both for the regulator and for those subject to regulation.

Equity Market

At the end of 2001 there were 1,160 companies listed on the two stock exchanges, with a total capitalization of RMB ¥43,522 billion accounting for 45 per cent of China's GDP (CSRC, 2002). Although this capital market is still immature, Regulator E suggested that it both motivates, and provides a greenhouse for, experimenting with accounting standards. This can be seen from the fact that accounting standards developed in China are mainly applicable to listed companies. However, as explained below, the capital market is characterized by weak equity outsiders, strong market speculation, weak form efficiency, extensive earnings management and deceptive reporting, and large-scale market manipulation.

Equity outsiders remain relatively unimportant for several reasons. First, banks continue to be a major source of finance (PBC, 2002) while state-owned shares accounted for 46.2 per cent of all listed shares as at the end of 2001 (CSRC, 2002).¹² Second, Wei (2001) found that at the end of 1999, the largest shareholder owned an average of 46.5 per cent of a company's shares and had an average representation of 70.5 per cent on the board of directors. In addition, some 65 per cent of company shares are not traded publicly, being held by promoters (including all state-owned shares), domestic legal persons, overseas legal persons and employees (CSRC, 2002). As these shares are not publicly tradable on the secondary market, their holders do not care so much about market price changes and need relatively less information for investment decision making compared with normal investors. Moreover, these shareholders usually have access to inside information, further reducing their reliance on external financial reporting.

There is also a high level of market speculation and manipulation in China. The investment strategy of most Chinese shareholders is to follow the market price, making the market highly speculative. Holders of tradable shares have a short time horizon, resulting in the average length of shareholding being only two months (Wei, 2001). As a result, investors prefer capital gains to cash dividends (Wei, 2001). In addition, there have been numerous cases of large scale market manipulation (Wang, 2001). Zhao (2000) and Wang (2001) reveal that investment funds and securities companies have played a key role in manipulating the market. As a result of speculation and market manipulation, market prices are highly volatile. This, in turn, reinforces investors' opportunism and short-termism and reduces the value of accounting information. This high degree of speculation and market manipulation, together with the existence of a large proportion of non-tradable shares, caused Auditor A to suggest that in China nobody wants 'true' (i.e., reliable) accounting information, not even the government.

¹² The average ratio of total equity to total assets for 233 listed firms between 1993 and 2000 is 54 per cent.

Moreover, both internal and external corporate governance mechanisms are weak or non-existent in China. For example, externally the market for corporate control and managerial labour market are seriously underdeveloped, while internally it was not until 2002 that independent directors and audit committees appeared in listed companies. Not surprisingly, in a study of earnings management it was found that companies increased their non-recurring income to satisfy a regulation requiring a 10 per cent return on net assets as a condition for a rights issue of shares (Haw *et al.*, 1998). The problem of creating fictitious transactions to falsify profits or conceal speculation appears much more severe than earnings management and leads to lack of confidence in annual reports or an accounting 'information crisis' as mentioned earlier (Chen *et al.*, 2000). These irregularities in financial accounting and reporting suggest that the capital market does not provide sufficient monitoring of opportunistic behaviour, nor does it provide sufficient incentives for listed companies to supply high quality information.

The Chinese regulators are aware of the weaknesses of the capital market and its impact on the demand for, and supply of, accounting information. It is evident that the poorly developed equity market has had an impact on the regulators in choosing an approach to accounting regulation and in prioritizing the needs of different users. Liu (2000, p. 3), then Deputy Director (now Director) of Department of Accounting Affairs Management, openly acknowledges that accounting regulators in China 'have given significant consideration to the accounting information requirements of the government although also taking account of the information needs of the public and other users'. He suggests that the emphasis on the government's information needs reflects a key feature of the Chinese capital market: that almost all listed companies were transformed from state-owned enterprises, and that state-owned assets thus dominate the firms' capital structures. He also attributes this emphasis to the fact that the Chinese capital market is embryonic, small in scale, has a large proportion of irrational investors, and is not yet an efficient mechanism for resource allocation.

Apart from these negative effects on accounting regulation, the poorly developed capital market in China has also placed many constraints on the adoption of accounting methods. For example, the Enterprise Accounting System had to suspend the adoption of the fair value approach to valuation of assets, which was previously stipulated in an accounting standard, because it is impossible to obtain a fair value for many assets in the Chinese capital market. This indicates that an immature capital market provides a poor context within which accounting standards may evolve and develop.

Our analysis shows that although the capital market has played an important role in accounting standard setting in China, its continued structural weaknesses and significant imperfections have seriously restricted the supply of, and demand for, decision-useful accounting information and IAS-type accounting standards.

The Accounting Tradition and Other Inertial Factors

As described earlier, China adopted a UAS in the early 1950s as a result of major political changes, but has subsequently created a domestic tradition in perpetuating

forms of a UAS. This section examines how this tradition affects current accounting regulation, and shows how factors other than the political and market ones discussed above may have caused this tradition to persist.

First, it should be noted that the presence of a UAS has been perceived as a stabilizing force and remains highly valued. For example, Li (2001, p. 2), then Assistant (now Deputy) Minister of Finance, states that China has always adopted a UAS to regulate accounting and that this has informed China's unique accounting regime since its foundation. He argues that the UAS is so important because the UAS has become a practical tool for accountants and has provided a reliable basis for auditing and taxation over the years. He also attributes the importance of the UAS to its detailed nature and argues that the more detailed the UAS the better.

This accounting tradition of reliance on a UAS has, however, resulted in a poor infrastructure for implementing accounting standards in terms of the readiness of preparers, auditors, regulators and users (AAA, 2000). Asked why the ASBE was accompanied by a set of industry-specific UASs, Regulator D pointed to the fact that Chinese enterprises and accounting firms are not capable of developing their own accounting systems. Tang (2000), an eminent Chinese accounting academic and member of the Chinese Accounting Standards Committee, finds that preparers are reluctant to adopt accounting standards because they do not understand their conceptual underpinnings, are unused to the concept of accountability, and take a mistaken view that increased transparency will cause trouble for the company and managers.

The relatively young Chinese auditing profession provides insufficient support for accounting standards, because auditors lack both professional training and independence (Xiang, 1998). As a result of a lack of sophisticated users and providers of accounting information, Chinese auditors have enjoyed an almost litigation-free environment. Although some auditors have been heavily penalized for being caught in publicly exposed major financial scandals (Xiao *et al.*, 2000), there exists extensive but unrevealed auditor-client corruption and collusion (Auditor A). As a result, there is a considerable lack of confidence in Chinese auditors even by regulators, as can be seen from the requirement that initial public offerings and additional issues of securities to domestic shareholders be audited by both domestic and international auditors (CSRC, 2001). Finally, a UAS helps users who are generally unsophisticated in their understanding of the required accounting processes; it is also more suitable for regulators, as they are more experienced in drafting a UAS than in setting accounting standards.

The inertial aspect of the UAS is acknowledged by Academic C, who remarked that Chinese accountants have 'been accustomed to' it when asked why a UAS is needed. Regulators have promoted UASs by appealing to their familiarity for Chinese accountants. For example, Feng (1999, p. 5), then Director of Department of Accounting Affairs Management and now Assistant Minister of Finance, recognizes UASs as an enormous contributor to wealth for China because they have been cemented with accountants' wisdom and experience and have educated several generations of accountants. According to her, Chinese regulators are so familiar with UASs that they have developed accounting standards on the basis of UASs and should not neglect this realistic basis in future accounting standard setting.

Similarly, commenting on the Enterprise Accounting System, Liu (2001a, p. 3) argues that the form of a UAS is suited to Chinese thinking and custom and that a realistic and practicable approach to accounting regulation is to incorporate international conventions into the table of accounts, provide guidelines on how to use these accounts, and prescribe the formats of financial statements and guidelines on how to prepare these statements. He further suggests that the adoption of the form of a UAS in the Enterprise Accounting System reflects the preference of an absolute majority of accounting practitioners.

The accounting tradition of reliance on a UAS is reinforced because many Chinese accountants and auditors lack professional education and training (Xiang, 1998). This problem has its origins in the shortage of trained accountants in the 1960s, exacerbated by the cessation of accounting education during the Cultural Revolution (Yan and Wang, 2000). Accounting principles and standards were discussed in academic circles in the early 1980s, but even leading academics simply equate the words 'accounting standards' with basic accounting postulates and principles such as accounting entity and realization (Regulator E). Yan and Wang (2000) have suggested that until recently, accounting education in China has been based on UASs; it lacks a conceptual underpinning and an international outlook. As a result, higher levels of educational attainment in accountants and auditors in more recent years remain relatively rare. Poorly educated accountants would find it very difficult to rely upon accounting standards for guidance in their routine work. Regulator B recognized the implications for accounting regulation, as can be seen from his following remarks:

We recommended the coexistence of accounting standards and a UAS because of the quality of accountants. There are 14 million accounting staff in China. Over 90 per cent of them are graduates from middle schools, high schools and technical schools. They do not understand the role of accounting, nor can they exercise professional judgment. It is impossible for them to select from FIFO, LIFO and WAC.

The accounting tradition is further reinforced by the Chinese culture. China is said to have a collectivism-orientated societal value and a relatively low degree of professionalism (Chow *et al.*, 1995, following Gray, 1988). Independence, belief in individual decisions and respect for individual endeavor are not emphasized. People do not take responsibility for something that has not been approved by systems and rules. Collectivism thus supports devising UASs and making accounting policy at the national level rather than within individual firms. This mentality is widely reflected in accounting and auditing practices in China. DeFond *et al.* (1999) observe that government controls both auditors and their clients.

Furthermore, although China has moved from the 'political accounting' of the Cultural Revolution to economic accounting, the shadow of political and class struggle remains. The impact is usually a resistant attitude towards accounting practices developed in capitalist countries. For example, according to Regulator B it would have been impossible for the ASBE to be issued without Deng Xiaoping's bold call for rapid change towards a market economy in 1992 because the ASBE contains principles previously perceived to be capitalist tools. Chinese regulators are aware of such resistance and thus have to stress the need to develop and

protect characteristics of the Chinese accounting system (Ministry of Finance, 1995). As a result, a considerable effort has been made to search for Chinese characteristics (e.g., Liu, 2000, 2001a; Qu, 2000; Zhu, 2001). The retention of the form of a UAS can be seen as maintaining a Chinese characteristic or tradition (Li, 2001).

Nevertheless, aware of the negative impact of the traditional reliance on a UAS, the Chinese government has addressed this by implementing several measures. Apart from promoting higher education in accounting so that almost every higher education institution provides accounting courses, the government has established the National Institute of Accounting in Beijing, Shanghai and Xiamen to provide executive courses relating to accounting for auditors, preparers and regulators. The Ministry of Finance has administered a national qualification examination for industrial accountants for more than ten years, while the Chinese Institute of Certified Public Accountants has operated a national qualification examination for auditors since the early 1990s. To improve the credibility of auditing, the Ministry of Finance has issued Independent Auditing Standards since 1994, conducted an annual review of auditor qualifications for auditing listed companies jointly with the CSRC, and completed a five-year campaign to disaffiliate auditor firms from sponsoring government departments between 1994 and 1998. As a result, auditor independence is improving (e.g., DeFond *et al.*, 1999).

Our analysis suggests that the accounting tradition has created an inertia which constrains innovation of accounting systems and an accounting infrastructure that is suited to the implementation of UASs but not to the adoption of accounting standards. This accounting tradition has also been reinforced by several social and cultural factors. The inertia, the infrastructure and the reinforcing factors together make the UAS an aid to introducing the greater professionalism and choice represented in IAS-type accounting standards.

CONCLUSION

This article suggests that a strong political influence, together with the factors of a weak equity market and the tradition of relying on a UAS, helps explain the co-existence of a UAS and IAS-type accounting standards in China. This finding reinforces the analysis of Ball *et al.* (2000) and extends Nobes (1998) by showing that political factors have strongly influenced the nature of the accounting system in a developing economy. Further, because of both self-motivation and external pressure, the Chinese government has been active in developing accounting standards in harmony with IAS. However, it has retained a UAS in consequence of China's special circumstances. These include direct government involvement in accounting regulation, strong state ownership, an immature accounting profession, a weak and imperfect equity market, regulators' relatively stronger expertise in devising a UAS than in developing accounting standards, an accounting infrastructure developed under the tradition of a UAS, China's culture, and Chinese people's political sensitivity regarding foreign accounting theory and practice. These circumstances have weakened the demand for, and supply of, accounting standards, making it difficult to adopt IAS and abandon the UAS tradition.

It could be suggested that the Ministry of Finance is clinging to the past in regularly revitalizing a UAS. That suggestion is countered by the move to incorporate elements of IAS directly into the Enterprise Accounting System, and the simultaneous development of national accounting standards to complement the UAS. We conclude that the continued development of a UAS in the new Enterprise Accounting System is consistent with Nobes' classification of China as moving towards a target of a market-focused accounting system. We see the UAS as a necessary support for the process of implementing a market-focused accounting system. More widely, an understanding of political influence may be important in evaluating progress towards full implementation of IAS in developing economies.

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APPENDIX

A SUMMARY OF THE ENTERPRISE ACCOUNTING SYSTEM

Part I has fourteen chapters, which contain detailed accounting principles and methods but, *inter alia*, the early chapters could be regarded as bringing aspects of the IAS Framework (IASC, 1989) to Chinese accounting, thereby enhancing understanding of principles of financial reporting.

Chapter 1 prescribes a list of accounting principles, concepts and qualitative characteristics, including: the accounting entity, going concern, accounting period, substance over form, consistency, the accrual basis, matching, historical cost, distinction between capital expenditure and revenue expenditure, prudence, timeliness, understandability, and materiality.

Chapters 2 to 7 define elements of financial statements: assets, liabilities, owners' equity, revenues, costs and expenses, and profits, consistent with the IAS Framework. There is further classification and definition of sub-elements, with rules on permissible accounting methods. A separate section in chapter 2 deals with provision for impairment in short-term investments, loans, accounts receivable, stock, long-term investments, fixed assets, intangible assets, and construction in progress, based on regular inspection and revaluation.

Chapters 8 to 12 prescribe accounting principles or methods for non-monetary transactions, foreign currency translation, adjustments, contingent items, and related party transactions. The Enterprise Accounting System is consistent with IAS in terms of accounting for leases, construction contracts, accounting for post-balance sheet events, accounting for foreign currency translations, disclosure of contingent items, related parties and transactions, and the cash flow statement.

Chapter 13 prescribes financial statements, requirements for their submission, and minimum disclosure in the footnotes. The balance sheet and the income statement should be prepared half-yearly and annually, with the cash flow statement being prepared at least annually. The balance sheet should be supplemented with a statement of provisions for asset impairment and a statement of changes in owners' equity. The income statement should be supplemented with a statement of profit distribution and a segmental report either by line of business or by geographical area.

Part 2 provides the basis of a chart of accounts by prescribing eighty-five general ledger accounts, sub-accounts, and their application. It prescribes the layouts of the financial statements and guidance on the preparation of the financial statements and footnotes.

Part 3 is an appendix containing illustrative accounting entries and treatments for a range of transactions including current assets, long-term investments, fixed assets, intangible assets, long-term deferred assets, deferred income or loss, accounts payable or receivable, owners' equity, costs and expenses, revenues, profit and profit distribution.

GEORGE GEORGIU

Corporate Lobbying on Accounting Standards: Methods, Timing and Perceived Effectiveness

There is a long-standing concern in the literature about the potential importance of non-observable forms of lobbying that may be used by corporate managers to influence accounting standard setting bodies. To date, however, no study has documented their nature or their volume. This study provides such evidence in the context of the U.K.'s Accounting Standards Board (ASB) standard setting process for the period 1991–96. It also provides evidence with respect to the timing at which lobbying activity takes place and its perceived effectiveness by corporate managers. The findings suggest that companies use a variety of lobbying methods, including appeals to their auditors and private meetings with ASB members and staff. Importantly, however, the use of these methods is significantly associated with the use of comment letters; companies which submit comment letters are much more likely to use other methods than companies which do not. Other findings suggest that more companies lobby during the stages of the ASB process at which public consultation takes place (e.g., exposure period of a discussion paper) than at the earlier stages of the process (e.g., agenda formation) which are considered in the literature as the stages at which lobbying can be most effective. With respect to the perceived effectiveness of lobbying, companies which lobbied the ASB considered lobbying to be more effective than companies which did not.

Key words: Accounting standards; ASB; Lobbying.

Corporate lobbying behaviour in accounting standard setting has been the subject of a considerable number of studies. In the main, these studies have a narrow aim, that is, to establish, by examining the comment letter submissions, the motives of companies to lobby the standard setter. An accounting standard setting process, however, is a political lobbying process and as such it offers potential participants several opportunities and means by which they can influence its outcomes (Sutton, 1984). Corporate lobbying decisions, therefore, would involve a number of interrelated issues. These include: whether to lobby or not; which method(s) of lobbying to use (e.g., submission of comment letters or meetings with the standard setter); when to lobby (e.g., during the drafting stage of a discussion paper or after its exposure for public comment); and what arguments to use to support a

position (e.g., theoretical or economic consequence arguments). Several authors have suggested that the examination of all of the above issues is essential for a full understanding of corporate lobbying behaviour (e.g., Walker and Robinson, 1993; Weetman *et al.*, 1996).

Despite these calls, a very limited amount of research has been undertaken to investigate systematically either the nature or volume of forms of lobbying other than comment letters or the timing at which they are employed. Gavens *et al.* (1989) is an exception to this trend and provides evidence with respect to the use of indirect lobbying means (e.g., lodging submissions through a special interest group such as a trade organization). Another relevant study is that by Geiger (1993) which examined the procedures that the U.S. Auditing Standards Board used in adopting SAS 58, *Reports on Audited Financial Statements* (AICPA, 1988). Although that study analysed the written responses, it also considered the influence that other lobbying had on the final audit report wording, for example, conversations and liaison meetings involving board members and staff with outside interest groups such as the Financial Executives Institute and the Securities and Exchange Commission. Finally, Hodges and Mellett (2002) also report evidence that forms of lobbying other than comment letters were used by companies in their attempts to influence the ASB's accounting standard on the private finance initiative. This paucity of research is surprising, given the well established tradition in the field of politics to investigate—using questionnaire surveys and interviews—the lobbying activity to which government bodies are subjected (Milbrath, 1963; Berry, 1977; Schlozman and Tierney, 1986; Walker, 1991; Heinz *et al.*, 1993; Hofrenning, 1995).

The current study extends the literature on corporate lobbying by investigating other forms of lobbying in the context of the ASB standard setting process. It specifically examines the lobbying activity of a sample of U.K. listed companies over a six-year period, 1991–96, that is, the first six years of ASB's tenure. Through a questionnaire survey, evidence was obtained concerning the lobbying methods the sample companies used, the stages of the process at which they employed these methods, and the perceived effectiveness of their lobbying. The choice of the study period offers the opportunity to examine, in follow-up studies, whether corporate lobbying behaviour during the initial years of a standard setter's life is different from that of later years.

It is acknowledged that the reported findings are subject to certain limitations as some of the evidence obtained may be the result of 'gaming' on the part of the respondents. For example, it is possible that some respondents were concerned about revealing whether or not they used non-observable lobbying methods that might be considered as contrary to the public interest.¹

¹ Given this potential bias, extra care was taken in the drafting of the letter accompanying the questionnaire to assure potential respondents that all the information they provided would be held in the strictest of confidence. Respondents were assured that the results would be reported in aggregate and that neither their name nor that of their companies would in any way be associated with them.

THEORETICAL FRAMEWORK AND DEVELOPMENT
OF HYPOTHESES

The analysis of corporate lobbying behaviour can be undertaken from different theoretical perspectives. Rational choice theory suggests that lobbying behaviour is determined by self-interest and the concept of choice. Therefore, the choice of a party to lobby or not is considered to be a function of lobbying costs and benefits accrued from successful lobbying. Another relevant theoretical framework is that of the political economy of accounting (Cooper and Sherer, 1984). This framework views private standard setting arrangements as a reflection of the power relations in society, designed to defend and perpetuate the interests of a few dominant groups, for example, large multinationals (Sikka, 2001). Therefore, an analysis of lobbying costs and benefits, suggested by rational choice models as a method of understanding corporate lobbying, is considered less important than a broader examination of the social context within which standard setting arrangements take place.

This article follows in the tradition of the first framework. Specifically, it adopts the rational choice model developed by Sutton (1984) for the purpose of explaining U.K. corporate lobbying activity. This model attempts to explain the decision of interested parties to lobby at a single episode of the standard setting process. An interested party is presumed to lobby a standard setting body when the difference in utility that it assigns to two possible outcomes of the standard setting process, outcomes a and b ($U_a - U_b$), discounted by the probability that its lobbying will make a difference to the outcome of the process (p), exceeds the cost of lobbying (C). Hence a party would lobby only when $(U_a - U_b) * p > C$.

Based on this model, Sutton (1984) proceeds to make predictions as to when lobbyists are likely to lobby and which lobbying methods they are likely to use. These predictions are discussed below, and on their basis hypotheses are developed in the context of the ASB process.

Timing of Lobbying

Sutton (1984, p. 88) suggests that an effective lobbyist will attempt to influence the standard setter at an early stage of the standard setting process, 'while his views are crystallizing', as at this stage the probability of influencing its outcome (p) is high; subsidising, for example, information to the standard setter by sponsoring research studies on accounting issues which have not even been included on the agenda. Jordan (1991, p. 180) iterates this view by suggesting that in the arena of politics 'there is an iron law from lobbyists that the time to influence legislation is the drafting or even the pre-drafting stage'.

The process by which the ASB adopts its accounting standards can be characterized as typical of those followed by other private sector standard setters (e.g., FASB, the Accounting Standards Review Board). It includes several stages during which a party may decide to lobby: the agenda stage; drafting stage of a discussion paper; issuance of the discussion paper for comment; drafting of the exposure draft; publication of the exposure draft for comment; and drafting of the

accounting standard. On some issues a public hearing or a working paper might also be included.

Given Sutton's predictions as to the effectiveness of early lobbying, it is expected that the earlier stages of the ASB process will be used by a greater number of companies. Hence the following hypothesis stated in its null form:

H1: There is no difference between the number of companies which lobby at the earlier and the later stages of the process.

Lobbying Methods and Their Perceived Effectiveness

Potential lobbyists have a range of lobbying methods from which to choose. These can be classified as either *direct*, where the lobbyists lobby the ASB directly, that is, they communicate directly with the ASB, or *indirect*, where the lobbyists lobby the ASB via a third party, that is, they communicate their views to a party they consider influential over the ASB's decision making processes (Sutton, 1984, pp. 89–90). Following Sutton's general discussion of direct and indirect methods, in the specific context of the ASB process, lobbying methods that a company can use are categorized as follows.

Direct methods include: (a) submitting letters in response to invitations to comment on discussion papers or exposure drafts; (b) speaking at public hearings; (c) having meetings with ASB members or technical staff (e.g., project directors); (d) having telephone conversations with ASB members or staff or speaking to them at conferences or in other settings; (e) having consultants working on particular projects. Indirect methods include lobbying through others such as: (a) commenting in the media; (b) trade or other organizations representing the interests of the company; (c) company's external auditors; (d) Financial Reporting Council (FRC) members; (e) the Consultative Committee of Accountancy Bodies (CCAB); (f) government officials; or (g) sponsoring research studies.

The lobbyist's choice of method will depend on its cost-effectiveness relative to other available methods; 'the one which offers him the most influence (increase in p) per unit of lobbying expenditure' (Sutton, 1984, p. 89). Clearly, this does not mean that a company will restrict its lobbying activity to the most cost-effective method. It will lobby using additional channels, or indeed all available channels, so long as the marginal benefit, that is, the benefit from ensuring a favourable outcome adjusted by the resulting increase in p (from using the additional channel), exceeds the marginal cost of using this channel. A company, therefore, will select the mix of methods which optimizes the probability that its lobbying would make a difference to the outcome of the process (p) and the cost of lobbying (C). Lindahl (1987, p. 65) supports this analysis by suggesting that 'a simple tallying of comment letters is not likely to capture the extent of participation by firms in lobbying, particularly once other channels for lobbying are opened'. Walker and Robinson (1993) also refer to a range of lobbying activities that can be undertaken by corporations. They point out that companies which use comment letters may be those which have comparatively little access to other lobbying methods; conversely, those which do not use comment letters may be those which employ

other lobbying methods. As indicated above, however, there is little empirical evidence as to how extensive is the use of these lobbying methods. Hence the following hypothesis stated in its null form:

H2: The use of lobbying methods other than comment letters is not different.

Sutton (1984) further suggests that the various lobbying methods are not equally effective. He argues, however, that it is not possible to rank *a priori* their cost-effectiveness. Based on observations of lobbyists' behaviour, he suggests that, of the direct methods, private meetings with board members are perceived by lobbyists as more cost-effective, while indirect methods such as making appeals to higher level bodies such as the U.S. congress or the U.K. accountancy bodies are considered more effective than other direct methods, such as making submissions to invitations to comment. He suggests, however, that the effectiveness of the various methods cannot be judged except on a case-by-case, lobbyist-by-lobbyist basis. Other authors also commented on the relative effectiveness of lobbying methods. Lindahl (1987, p. 63), for example, considers the submission of comment letters as a 'low-cost form of lobbying' and 'by no means necessarily the most effective, means of lobbying' (p. 70). To date, however, there is little evidence as to how effective companies perceive the various lobbying methods available to them to be. Hence the following hypothesis stated in its null form:

H3: Companies perceive all lobbying methods as equally effective.

RESEARCH DESIGN

Questionnaire Instrument

In order to obtain evidence relevant to the testing of the above hypotheses, a questionnaire instrument was developed (see Appendix). For this purpose, standard questionnaire design procedures were followed, including interviews with three companies and two London-based technical partners of international accounting firms, pre-testing, and a pilot questionnaire. The questionnaire obtained information concerning: (a) the stages of the process at which companies might have lobbied and the perceived effectiveness of their lobbying at those stages; this information was used to test the first hypothesis (H1); (b) the lobbying methods that companies might have used and the perceived effectiveness of these lobbying methods; this information was used to test the other two hypotheses (H2 and H3). Extra space was also provided and companies were invited to make any additional comments that they may have had.

Following Berry (1977), the companies' perceptions concerning the effectiveness of lobbying stages and methods (i.e., having an effect on the final outcome of the process) were obtained using a five-point Likert scale ranging from 'very effective' (1) to 'very ineffective' (5). Consistent with similar research done in the field of politics (e.g., Schlozman and Tierney, 1986), a decision was taken to give potential respondents a 'Do not know' option rather than forcing them to give an answer which might not have been well-informed.

Sample Selection and Response Rate

The objective of the study is to examine the lobbying behaviour of companies over a six-year period, 1991–96.² The population of companies was drawn from the FTSE Actuaries All-Share index as of 5 February 1997. On that date it included a total of 724 non-financial companies. Using Datastream, an examination of the listed status of the 724 companies revealed that 161 of them did not exist as listed companies throughout the study period. Exclusion of these 161 companies resulted in 563 companies which served as the study's population. The questionnaires were mailed to the finance director (by name) of each sample company in February 1997. As indicated earlier, the covering letter for the survey assured potential respondents that the survey results would be reported in aggregate and that their individual responses would be held in the strictest confidence. Out of these, 171 provided a usable response: a 30.4 per cent response rate. Given that the response rate was less than 100 per cent, further analysis was performed to determine the extent of non-response bias. This involved two types of comparisons: first, between early and late respondents, and second, between the 171 respondent companies and the rest of the population. The first comparison did not reveal any significant differences between early and late respondents (e.g., mean sales revenues [in millions] for early and late respondents were £1,500.2 and £1,964.4, respectively; t -value was -0.541 and $p = 0.590$). However, when the 171 respondent companies were compared to the rest of the population they were found to be significantly larger (when measured by sales revenues). Mean sales (in millions) for respondents were £1,731.8 as opposed to only £786.9 for the non-respondents; the t -value was -2.473 , significant at $p < 0.01$. Such bias is probably inevitable in questionnaire-based research of this nature. Size is endogenous to the lobbying decision (Olson, 1971); past studies have suggested that smaller companies are less likely to lobby (e.g., Griffin, 1982; Francis, 1987; Saemann, 1997; Van Lent, 1997) so it follows that they are also less likely to respond to a survey about lobbying. Thus, caution should be exercised in generalizing the results to smaller listed non-financial companies.

The questionnaires were generally answered by senior managers who should have been knowledgeable about their companies' lobbying activities. Thus, 50 per cent of the questionnaires were answered by the finance director; 21 per cent by the financial controller; 15 per cent by the chief accountant or accounting, audit or finance manager; and the remaining 14 per cent by respondents holding a number of other positions such as company secretary, treasurer or head of accounting. Ninety-eight per cent of the respondents had a professional accounting qualification, and 59 per cent had a university degree. A measure of the responses' reliability was obtained by conducting interviews (of approximately forty-five minutes each) with thirteen (8 per cent) randomly selected respondents approximately six months after the questionnaires were obtained. There were no inconsistencies between the questionnaire responses and the interview findings.

² Data for this study were obtained in early 1997 as part of a larger PhD project.

RESULTS AND DISCUSSION

The statistical analysis is based on parametric tests (i.e., ANOVA and *t*-tests). However, given the nature of the data involved (e.g., perceived effectiveness is measured on an ordinal five-point Likert scale), for all tests a non-parametric analog (e.g., Wilcoxon signed-rank, Mann-Whitney tests) was used to test the robustness of the parametric test results. In all cases the results were remarkably similar. Therefore, only the parametric results are reported; where, however, the data violated the normality assumptions the non-parametric result is also reported. All tests were two-tailed.

Timing of Lobbying

Table 1 reports the results with respect to the use of the six lobbying stages of the process.

In order to test the null hypothesis (H1) that there is no statistical difference between the use of the earlier and later stages of the process, the first three stages (agenda stage, drafting of discussion paper, exposure of discussion paper) were considered as the 'early' stages and the last three stages (drafting of exposure draft, exposure period of exposure draft, drafting of FRS) as the 'late' stages. Therefore, for both the early and late stages each company's score ranged from 0 to 3 (i.e., 0 given if no stage was used; 1 if one stage was used; 2 if two stages were used; 3 if three stages were used). A paired-samples *t*-test clearly indicated that the null hypothesis that there is no significant difference between the use of the early and late stages can be rejected ($t = -3.305$, $p < 0.01$). The non-parametric Wilcoxon signed-rank test confirmed this result ($Z = -3.302$, $p < 0.01$).

Contrary to expectations, an examination of the descriptive statistics showed that it was actually the later stages that were used more heavily by companies; the mean use for these stages was 0.7806, as opposed to 0.6065 for the earlier stages. Further analysis showed that the bulk of lobbying activity is undertaken during the

TABLE 1
LOBBYING AT DIFFERENT STAGES OF THE PROCESS

Stage of the process	Users	Non-users	% of respondents using this method (no. of users/ <i>N</i>)
Agenda formation stage (<i>N</i> = 159)	5	154	3.14
Drafting stage of Discussion Paper (<i>N</i> = 161)	17	144	10.56
Exposure period of Discussion Paper (<i>N</i> = 169)	86	83	50.89
Drafting stage of Exposure Draft (<i>N</i> = 160)	24	136	15.00
Exposure period of Exposure Draft (<i>N</i> = 169)	94	75	55.62
Drafting stage of Financial Reporting Standard (<i>N</i> = 162)	27	135	16.67

N = number of companies responding to this item.

two public consultation stages, that is, public exposure of discussion paper and exposure draft. Interestingly, there was no statistically significant difference in the number of companies which used these two stages, but a series of McNemar tests indicated that they were used by a significantly greater number of companies than any other stage of the process (e.g., comparisons between the use of exposure period and drafting stage of a discussion paper produced a $\chi^2 = 60.016$, $p < 0.01$).³

The expectation that the earlier stages of the process were likely to be used by more companies than the later ones was based on the assumption that lobbying early is perceived to be more effective than belated lobbying. Table 2 reports the effectiveness ratings given by companies to the various lobbying stages. It is noteworthy that only about half of the respondents rated the various stages, with the other half choosing the 'Do not know' option.

A one-way within subjects (repeated measures) ANOVA indicated that the different stages were considered to be significantly different in terms of their effectiveness ($F_{3,397, 224,222} = 8.645$, $p < 0.01$). A non-parametric test involving the Friedman test (given that the analysis involved one related sample) mirrored this result ($\chi^2 = 36.108$, $p < 0.01$). However, contrary to expectations, it was not the earlier stages that were considered to be more effective. For example, the least effective stage was considered to be the earliest stage (i.e., agenda stage) which was rated as effective or very effective by only 26.4 per cent of the respondents. A series of paired-samples *t*-tests indicated that the two stages which were used by most companies (i.e., the exposure period of discussion paper and exposure draft), were also considered to be more effective than any other stage (e.g., comparisons between the effectiveness ratings of the exposure period and drafting stage of a discussion paper produced a $t = 3.707$, $p < 0.01$). Again there was no significant difference between the effectiveness ratings given to these two stages ($t = -0.238$, $p = 0.812$).

Therefore, though the literature suggests that, for any regulatory process, lobbying at the earlier stages (e.g., agenda stage) can be instrumental in terms of influencing outcomes, companies did not share this view in the context of the ASB process. This finding may reflect the reluctance of respondents to admit that they were involved in early lobbying and that they were actually influential in shaping the ASB's agenda because they might have considered such lobbying as contrary to the public interest.

Alternatively, the finding may indicate that the literature does not hold for corporate lobbying of accounting standard setters or it may be unique to the ASB at the time. During the initial years of its tenure the ASB might have been reluctant to let financial statement preparers be heavily involved and influence accounting standards at the early critical stages of their development in order to avoid the criticism levelled at its predecessor (the Accounting Standards Committee) that it was not independent of the preparers' interests. The ASB might have achieved

³ In this case only the non-parametric test was carried out because the data were in a nominal form (i.e., whether a company used a particular method), and a parametric test would therefore not have been appropriate.

TABLE 2
EFFECTIVENESS OF STAGES

	1 Very effective (%)	2 Effective (%)	3 Neither effective nor ineffective (%)	4 Ineffective (%)	5 Very ineffective (%)	Mean of Likert score	SD of Likert score
Agenda formation stage (<i>N</i> = 72; <i>DK</i> = 87; <i>NR</i> = 12)	1.4	25.0	34.7	18.1	20.8	3.32	1.11
Drafting stage of Discussion Paper (<i>N</i> = 81; <i>DK</i> = 80; <i>NR</i> = 10)	6.2	29.6	22.2	21.0	21.0	3.21	1.25
Exposure period of Discussion Paper (<i>N</i> = 114; <i>DK</i> = 55; <i>NR</i> = 2)	7.0	40.4	29.8	16.7	6.1	2.75	1.02
Drafting stage of Exposure Draft (<i>N</i> = 88; <i>DK</i> = 72; <i>NR</i> = 11)	5.7	34.5	28.7	14.9	16.2	3.01	1.18
Exposure period of Exposure Draft (<i>N</i> = 117; <i>DK</i> = 52; <i>NR</i> = 2)	4.3	47.9	28.2	12.8	6.8	2.70	0.98
Drafting stage of Financial Reporting Standard (<i>N</i> = 89; <i>DK</i> = 73; <i>NR</i> = 9)	7.9	33.7	21.3	16.9	20.2	3.08	1.28

N = number of companies which gave a rating to the effectiveness of this stage of the process.

DK = number of companies which chose the 'Do not know' option.

NR = number of companies which did not respond to this particular item of the question.

TABLE 3

COMPARISON OF USERS' AND NON-USERS' PERCEPTIONS

Stage	Users			Non-users			t-test	
	<i>n</i>	Mean	<i>SD</i>	<i>n</i>	Mean	<i>SD</i>	<i>t</i>	<i>p</i>
Agenda formation stage (<i>N</i> = 72)	4	2.75	0.50	68	3.35	1.13	2.115	0.087
Drafting stage of Discussion Paper (<i>N</i> = 81)	14	2.21	0.70	67	3.42	1.24	4.995	0.000 ^a
Exposure period of Discussion Paper (<i>N</i> = 114)	71	2.58	0.98	43	3.02	1.03	2.304	0.023 ^b
Drafting stage of Exposure Draft (<i>N</i> = 88)	21	2.29	0.72	67	3.24	1.20	4.440	0.000
Exposure period of Exposure Draft (<i>N</i> = 117)	81	2.65	0.92	36	2.81	1.12	0.765	0.446 ^c
Drafting stage of Financial Reporting Standard (<i>N</i> = 89)	24	2.38	0.92	65	3.34	1.30	3.880	0.000 ^d

N = number of companies which gave a rating to the effectiveness of this lobbying stage.

^a Mann-Whitney (MW): $Z = 0.338$, $p = 0.001$.

^b MW: $Z = -2.040$, $p = 0.041$.

^c MW: $Z = -0.533$, $p = 0.594$.

^d MW: $Z = -3.225$, $p = 0.001$.

this, for example, by keeping its agenda too vague and thus not enabling companies to participate at this stage in a proactive manner. Clearly, some companies are aware of the ineffectiveness of getting involved late in the process. The additional comments made by one of the companies at the end of the questionnaire are characteristic of this awareness:

It is an interesting debate that you touch on—the participation in the ASB standard setting process. It is widely acknowledged that industry is not involved early enough before the proposals are made and the ball is rolling and then becomes frustrating that even after strong points are made, the ASB comes on strictly with its original proposals.

To control for the impact that the actual use of the various stages had on the companies' perception of the effectiveness of these stages, the results of Table 2 are partitioned into those relating to users (companies which indicated that they used them) and non-users (companies which did not). They are reported in Table 3. Given that this involved two groups of companies and not one related sample, a series of independent *t*-tests were carried out. They reveal that users considered lobbying as significantly more effective than did non-users. The only exceptions to this finding relate to lobbying at the agenda stage and the exposure period of exposure draft. Mann-Whitney tests confirmed these results.

In summary, contrary to expectations, companies do not seem to concentrate their lobbying activities during the early stages of the process and do not consider early lobbying to be more effective than belated lobbying. In general, however, companies which did lobby considered lobbying to be more effective than companies which did not.

CORPORATE LOBBYING ON ACCOUNTING STANDARDS

TABLE 4
LOBBYING METHODS

Lobbying method	Users	Non-users	% of respondents using this method (no. of users/ <i>N</i>)
Direct methods			
Submitting comment letters in response to ASB's invitations to comment (<i>N</i> = 167)	87	80	52.10
Speaking at ASB public hearings (<i>N</i> = 162)	10	152	6.17
Communicating your company's views to ASB members in prearranged private meetings (<i>N</i> = 163)	41	122	25.15
Communicating your company's views to ASB members through other means (e.g., telephone conversation, meeting at conferences) (<i>N</i> = 162)	37	125	22.84
Communicating your company's views to ASB staff in prearranged private meetings (<i>N</i> = 163)	22	141	13.50
Communicating your company's views to ASB staff through other means (e.g., telephone conversation, meeting at conferences) (<i>N</i> = 164)	28	136	17.07
Indirect methods			
Commenting in the media (<i>N</i> = 162)	12	150	7.41
Appealing to FRC members for support of your company's views (<i>N</i> = 162)	2	160	1.23
Appealing to your company's external auditors for support of your company's views (<i>N</i> = 164)	89	75	54.27
Appealing to your company's trade organization(s) for support of your company's views (<i>N</i> = 161)	36	125	22.36
Having members of your company appointed as consultants to the ASB on particular projects (<i>N</i> = 162)	14	148	8.64
Sponsoring research studies on financial accounting and reporting issues (<i>N</i> = 162)	3	159	1.85

N = number of companies responding to this item.

Lobbying Methods

Table 4 reports the responses of companies to the question on whether they used the twelve lobbying methods specifically identified in the questionnaire.⁴

The results reject the null hypothesis (H2) that there is no significant use of lobbying methods other than comment letters. In fact comment letters were not found to be the most popular method; 87 companies claimed their use as opposed to 89 companies that appealed to their external auditors. Other methods were

⁴ Eight companies indicated the use of the following methods in the additional space provided: 'Institute of Chartered Accountants of Scotland', 'Commenting in annual report and accounts', 'Member of Midlands Group of Finance Directors', '100 group' (two companies), 'Scottish group of finance directors', 'Writing to ASB', and 'Consultation from ASB post-exposure of FRED 1'.

also found to be popular; pre-arranged meetings with ASB members or communication with them at other forums were used by 41 and 37 companies, respectively, while appeals to trade organizations were used by 36 companies.

Therefore, overall, a considerable number of companies used lobbying methods for which there is no evidence in the public domain. Given the uncertainty in the literature as to whether the companies which undertake this lobbying activity are the ones which also lobby through comment letters or are those which do not make submissions (Walker and Robinson, 1993), it is important to examine whether there is a significant association between the use of comment letters and that of other lobbying methods. For this purpose cross-tabulation analysis and the Chi-square statistic were used involving the use of comment letters and (a) the use of each of the twelve methods identified in the questionnaire and (b) the use of at least one other method. The results, reported in Table 5, show a strong association between the use of comment letters and the use of most other lobbying methods.⁵ Except for the associations between comment letter submissions and appeals to FRC and sponsoring research studies, all the other Chi-square results are significant at the 0.05 level.

Given this result, it is not surprising that 81 out of the 87 companies (93.1 per cent) which indicated that they used comment letters also indicated that they used at least one more method (see last entry in Table 5). In contrast, only 35 (44.3 per cent) of the 79 companies which indicated that they did not make a submission used at least one more method (see last entry in Table 5). Further analysis indicated that, from these 35 companies, only 14 of them used direct lobbying methods (e.g., meetings or communication with ASB members or staff), while the other 21 relied on other parties such as their auditors and trade organizations. Therefore, it appears that the bulk of lobbying activity in forms other than comment letters is undertaken by those companies which also submit comment letters. This means that overall comment letters appear to be a good proxy for the use of other, less overt, lobbying methods.

Table 6 reports the results with respect to the perceived effectiveness of these methods.

A one-way within subjects (repeated measures) ANOVA indicated that the null hypothesis (H3) that companies perceive all lobbying methods to be equally effective can be rejected ($F_{6,734, 343.432} = 10.806, p < 0.01$); the Friedman test result ($\chi^2 = 100.197, p < 0.01$) confirmed this.

⁵ A few differences between the numbers reported in Table 5, as well as between it and Table 4, are due to the fact that not all of the companies which indicated that they used or did not use comment letters indicated whether they used all of the other methods identified in the questionnaire. For example, out of the 80 companies which indicated that they did not use comment letters (see first row of Table 4) only 79 indicated whether they used or did not use prearranged meetings with ASB members; 68 indicated that they did not use them and 11 responded that they did (see second row of Table 5). On the other hand, only 78 companies out of the 80 companies which indicated that they did not use comment letters indicated whether they used or did not use trade organizations; 71 responded that they did not use them and 7 indicated that they did (see ninth row of Table 5).

CORPORATE LOBBYING ON ACCOUNTING STANDARDS

TABLE 5
CROSS-TABULATION ANALYSIS

		Comment letter		χ^2	<i>p</i>
		Non-user	User		
Speaking at public hearings	Non-user	79	73	10.144	0.001
	User	0	10		
Prearranged meetings with ASB members	Non-user	68	54	10.268	0.001
	User	11	30		
Other communication with ASB members	Non-user	73	52	23.040	0.000
	User	5	32		
Prearranged meetings with ASB staff	Non-user	77	64	15.787	0.000
	User	2	20		
Other communication with ASB staff	Non-user	77	59	21.842	0.000
	User	2	25		
Commenting in the media	Non-user	77	73	5.344	0.021
	User	2	10		
Appeals to FRC members	Non-user	79	81	1.927	0.165
	User	0	2		
Appealing to external auditors	Non-user	51	24	21.223	0.000
	User	28	60		
Appealing to trade organization(s)	Non-user	71	54	15.616	0.000
	User	7	29		
Having consultants on ASB projects	Non-user	79	69	14.586	0.000
	User	0	14		
Sponsoring research studies	Non-user	78	81	0.291	0.589
	User	1	2		
Use of at least one method (other than comment letters)*	Non-user	44	6	46.845	0.000
	User	35	81		

* Includes the eight companies which used methods not specified in the question (see note 4).

As Table 6 shows, having consultants working on ASB projects was considered the most effective method; mean of 2.54 and 62.9 per cent of the respondents considered it as effective or very effective. Pre-arranged meetings with ASB members were also considered effective by the majority of respondents (rated as effective or very effective by 53.4 per cent). According to Sutton (1984, pp. 89-90), companies consider such meetings as more effective than other direct lobbying methods. Both paired-samples *t*-tests and Wilcoxon signed-rank tests showed this to be largely true. Pre-arranged meetings with ASB members were considered to be more effective statistically at the 0.05 significance level than communication with ASB members or staff through other means, such as telephone conversation, public

TABLE 6
EFFECTIVENESS OF LOBBYING METHODS

	1 Very effective (%)	2 Effective (%)	3 Neither effective nor ineffective (%)	4 Ineffective (%)	5 Very ineffective (%)	Mean of Likert score	SD of Likert score
Submitting comment letters in response to ASB's invitations to comment ($N = 113$; $DK = 54$; $NR = 4$)	11.5	41.6	24.8	16.8	5.3	2.63	1.06
Speaking at ASB public hearings ($N = 83$; $DK = 79$; $NR = 9$)	4.9	26.5	32.5	25.3	10.8	3.11	1.07
Communicating your company's views to ASB members in prearranged private meetings ($N = 88$; $DK = 75$; $NR = 8$)	11.5	42.0	26.1	13.6	6.8	2.63	1.08
Communicating your company's views to ASB members through other means (e.g., telephone conversation, meeting at conferences) ($N = 88$; $DK = 74$; $NR = 9$)	3.4	25.0	43.2	19.3	9.1	3.06	0.98
Communicating your company's views to ASB staff in prearranged private meetings ($N = 81$; $DK = 82$; $NR = 8$)	11.1	30.9	29.6	18.5	9.9	2.85	1.15
Communicating your company's views to ASB staff through other means (e.g., telephone conversation, meeting at conferences) ($N = 80$; $DK = 84$; $NR = 7$)	5.0	21.2	35.0	26.3	12.5	3.20	1.07
Commenting in the media ($N = 82$; $DK = 80$; $NR = 9$)	0	24.3	29.3	30.5	15.9	3.38	1.03
Appealing to FRC members for support of your company's views ($N = 70$; $DK = 92$; $NR = 9$)	0	12.8	38.6	34.3	14.3	3.50	0.90
Appealing to your company's external auditors for support of your company's views ($N = 111$; $DK = 53$; $NR = 7$)	7.3	38.7	32.4	15.3	6.3	2.75	1.01
Appealing to your company's trade organization(s) for support of your company's views ($N = 76$; $DK = 85$; $NR = 10$)	3.9	30.3	30.3	17.1	18.4	3.16	1.17
Having members of your company appointed as consultants to the ASB on particular projects ($N = 70$; $DK = 92$; $NR = 9$)	18.5	44.3	14.3	10.0	12.9	2.54	1.27
Sponsoring research studies on financial accounting and reporting issues ($N = 64$; $DK = 98$; $NR = 9$)	0	12.5	39.1	29.7	18.8	3.55	0.94

N = number of companies which gave a rating to the effectiveness of this lobbying method.

DK = number of companies which chose the 'Do not know' option.

NR = number of companies which did not respond to this particular item of the question.

hearings or pre-arranged meetings with ASB staff. Importantly, however, they were not considered to be significantly more effective than comment letters ($t = 1.134$, $p = 0.260$; $Z = -0.938$, $p = 0.348$) which were considered as effective or very effective by the majority of respondents (53.1 per cent). The study's findings concerning the effectiveness of comment letters are consistent with those of Geiger (1993), who showed that the U.S. Auditing Standards Board did utilize the comment letters it received and well articulated ones were particularly influential in the process of promulgating SAS 58. Another interesting finding is that appeals to auditors were considered effective or very effective by 45.9 per cent of the respondents. Therefore, despite the changes in the U.K. standard setting arrangements aimed to reduce the influence of auditors (e.g., smaller representation of auditors in the membership of ASB), companies continue to perceive them as influential in the process.

Table 7 analyses the results into those relating to users and non-users of methods. Consistent with the results of the effectiveness of the various stages, users considered all lobbying methods to be more effective than did non-users (though the differences were not always significant at the 0.05 level). In general, however, it appears that experience in lobbying may improve the ability of companies to influence the standard setters or help them form more informed expectations concerning the potential success of their lobbying.

CONCLUSION

This article investigated the nature and extent of lobbying activity undertaken by a sample of U.K. listed companies over the period 1991–96. While recognizing the limitations of relying on questionnaire data, several conclusions can be drawn. The results provide strong support for Sutton's (1984) prediction that, in order to maximize the probability of influencing the standard-setter, companies employ a number of lobbying methods which they rate differently in terms of their effectiveness. Importantly, however, the companies which use these methods are likely to be those that also use comment letters rather than those which do not. The latter are unlikely to use any other lobbying means and in particular direct lobbying means. These findings suggest that comment letters are likely to be a good proxy of at least the direct corporate lobbying activity to which the ASB is subjected.

Contrary, however, to Sutton's predictions, companies do not seem to consider that lobbying at the early stages of the process is more effective than belated lobbying and thus do not seem to concentrate their lobbying activity during these early stages. This may reflect the reluctance of respondents to admit that they were influential during the earlier phases of the process, or it may be unique to the ASB at the time. It should be stressed that the period under study related to the first six years of the ASB's tenure (i.e., 1991–96) and that it is thus possible that the reported results are unique to the initial years of a standard setter's life and do not hold over time. For example, it may be argued that the perceptions and behaviour of corporate lobbyists change with the passage of time as they become more familiar with the *modus operandi* of the standard setter. Clearly,



TABLE 7

COMPARISON OF USERS' AND NON-USERS' PERCEPTIONS

	Users			Non-users			t-test	
	<i>n</i>	Mean	<i>SD</i>	<i>n</i>	Mean	<i>SD</i>	<i>t</i>	<i>p</i>
Submitting comment letters in response to ASB's invitations to comment (<i>N</i> = 113)	73	2.47	0.88	40	2.93	1.29	2.010	0.049 ^a
Speaking at ASB public hearings (<i>N</i> = 83)	10	2.60	0.97	73	3.18	1.07	1.617	0.110
Communicating your company's views to ASB members in prearranged private meetings (<i>N</i> = 88)	35	2.49	1.17	53	2.72	1.01	0.987	0.326 ^b
Communicating your company's views to ASB members through other means (e.g., telephone conversation, meeting at conferences) (<i>N</i> = 88)	32	2.63	0.79	56	3.30	0.99	3.316	0.001
Communicating your company's views to ASB staff in prearranged private meetings (<i>N</i> = 81)	18	2.50	1.20	63	2.95	1.20	1.480	0.143
Communicating your company's views to ASB staff through other means (e.g., telephone conversation, meeting at conferences) (<i>N</i> = 80)	22	2.86	0.94	58	3.33	1.10	1.751	0.084
Commenting in the media (<i>N</i> = 82)	11	3.00	0.77	71	3.44	1.05	1.649	0.118 ^c
Appealing to FRC members for support of your company's views (<i>N</i> = 70)	2	2.50	0.71	68	3.53	0.89	1.619	0.110
Appealing to your company's external auditors for support of your company's views (<i>N</i> = 111)	74	2.64	1.00	37	2.97	1.01	-1.669	0.098 ^d
Appealing to your company's trade organization(s) for support of your company's views (<i>N</i> = 76)	29	2.45	0.87	47	3.60	1.12	5.004	0.000
Having members of your company appointed as consultants to the ASB on particular projects (<i>N</i> = 70)	12	1.58	0.67	58	2.74	1.28	4.528	0.000 ^e
Sponsoring research studies on financial accounting and reporting issues (<i>N</i> = 64)	3	2.33	0.58	61	3.61	0.92	2.369	0.021

N = number of companies which gave a rating to the effectiveness of this lobbying method.

^a Mann-Whitney (MW): $Z = -1.876$, $p = 0.061$.

^b MW: $Z = -1.426$, $p = 0.154$.

^c MW: $Z = -1.292$, $p = 0.196$.

^d MW: $Z = -1.625$, $p = 0.104$.

^e MW: $Z = -3.111$, $p = 0.02$.

further research into U.K. corporate lobbying post-1996 could provide us with a fuller understanding of the applicability of Sutton's model to corporate lobbying in the U.K.'s ASB.

Similarly, care should be taken in generalizing the study's findings to other standard setting environments such as those, for example, of Australia and the

CORPORATE LOBBYING ON ACCOUNTING STANDARDS

U.S. This is because differences in the regulatory frameworks and culture across countries may influence corporate lobbying behaviour (MacArthur, 1993). Thus, more research investigating corporate lobbying in different countries is required in order to establish the general applicability of Sutton's model.

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APPENDIX

QUESTIONNAIRE INSTRUMENT

The ASB standard setting process includes a number of stages through which a proposal passes before it is adopted as a financial reporting standard (e.g., an issue has to be first admitted on the ASB's agenda). A company may participate in the process in a variety of ways (e.g., directly by communicating its views to the ASB, or indirectly by communicating its views to other parties, such as its external auditors or the Financial Reporting Council [FRC]).

Questions 1 and 2 relate to the *stages* at which, and the *methods* by which a company may participate in the ASB standard setting process. As appropriate, please tick Yes or No, and then tick the number on the effectiveness scale which best represents your opinion. Use the scale:

1 = Very effective 2 = Effective 3 = Neither effective nor ineffective 4 = Ineffective
5 = Very ineffective DK = Don't know

1. For each of the following *stages* of the ASB standard setting process, please indicate:

- (i) whether your company has participated at these stages over the period 1991 to 1996 inclusive; and
- (ii) regardless of whether your company has actually participated at these stages, how you rate participation at each stage in terms of effectiveness (i.e., having an effect on the final outcome of the process).

Stage of the standard-setting process	Actual use		Effectiveness scale						
	Yes	No	1	2	3	4	5	DK	
Agenda formation stage									
Drafting stage of Discussion Paper									
Exposure period of Discussion Paper									
Drafting stage of Exposure Draft									
Exposure period of Exposure Draft									
Drafting stage of Financial Reporting Standard									

2. For each of the following *methods of participating* in the ASB standard setting process, please indicate:

- (i) whether your company has used these methods over the period 1991 to 1996 inclusive; and

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- (ii) regardless of whether your company has actually used these methods, how you rate each method in terms of effectiveness (i.e., having an effect on the final outcome of the process)?

Method of participation	Actual use		Effectiveness scale					
	Yes	No	1	2	3	4	5	DK
Submitting comment letters in response to ASB's invitations to comment								
Speaking at ASB public hearings								
Communicating your company's views to ASB members in prearranged private meetings								
Communicating your company's views to ASB members through other means (e.g., telephone conversation, meeting at conferences)								
Communicating your company's views to ASB staff in prearranged private meetings								
Communicating your company's views to ASB staff through other means (e.g., telephone conversation, meeting at conferences)								
Commenting in the media								
Appealing to FRC members for support of your company's views								
Appealing to your company's external auditors for support of your company's views								
Appealing to your company's trade organization(s) for support of your company's views								
Having members of your company appointed as consultants to the ASB on particular projects								
Sponsoring research studies on financial accounting and reporting issues								
Other (please specify)								

3. If you have any additional comments to make please use the space provided below.

EDDY CARDINAELS, FILIP ROODHOOFT AND LUK WARLOP

Customer Profitability Analysis Reports for Resource Allocation: The Role of Complex Marketing Environments

Most decision making research in management accounting remains focused on cost information in a production context. Little is known on the relevance of customer profitability analysis (CuPA) reports, which more accurately reflect revenue and marketing support variations across customers, for marketing decisions. This study uses an experimental design to examine the impact of such reports on resource allocation decisions (that affect the firm's profits) in marketing environments varying in complexity. The main result of the experiment suggests that the value of CuPA reports depends on the complexity of the marketing setting. Only in a highly complex marketing setting do they enhance resource allocation decisions and resultant firm profitability. Conversely, in the simple marketing environment, decision makers can combine their traditional volume-based cost data with other available types of feedback to perform as well as under a more accurate CuPA report. These findings on complexity contrast with those of a prior study in a production context (Gupta and King, 1997). It is argued that improvements in the current research design, in the form of regularly updated profitability reports and concerning accuracy, increase the relevance of CuPA reports in a complex marketing setting.

Key words: Complexity; Customer profitability analysis; Decision making; Resource allocation.

This study provides experimental evidence on the role of more accurate customer profitability reports for repeated marketing resource allocation decisions. While there is some evidence of the role of accurate costing data for product decisions, little is known about how customer profitability data can be used strategically for assisting these typical marketing decisions (Foster and Young, 1997; Guilding and McManus, 2002). When managers make budget allocation decisions (e.g., sales visit budgets, advertising expenditures), it is argued that resources should be geared to customers that generate significant revenues while demanding little

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marketing support (Mulhern, 1999). Traditional cost reports often assume that marketing costs increase with volume, whereby each dollar of revenue contributes equally to net income (Selnes, 1992). Hence, variations in marketing support remain hidden and it is more likely that resources are misallocated to the customers with low profit potential. On the other hand, customer profitability analysis (CuPA) reports typically use non-volume based cost drivers (e.g., the number of deliveries, orders, etc.) of activity-based costing to accurately reflect important variations in marketing support across customers (Foster *et al.*, 1996; Kaplan and Atkinson, 1998). CuPA might therefore be extremely useful in directing resources to the customers with the highest profit potential (Goebel *et al.*, 1998; Mulhern, 1999).

On the other hand, the usefulness of CuPA, as opposed to volume-based profitability reports, is often questioned. In addition to cost reports, it is argued that the decision maker has many other sources of feedback on the cost and profit behaviour of a customer such as feedback from interacting with customers or outcome feedback of prior budget allocation decisions (Bruns and McKinnon, 1993; Malmi, 1997). Although traditional reports do not accurately reflect profit differences across customers, managers may still form efficient allocation decisions using this other feedback, and more accurate CuPA reports are alleged to have limited value (Malmi, 1997). It has been shown that, in simple settings, other types of feedback indeed allow the manager to address certain problems with biased costing data (Briers *et al.*, 1999; Dearman and Shields, 2001).

The contribution of our experiment is that environmental complexity is added as an important factor (in addition to the profitability report) to enrich the debate of whether more accurate CuPA reports are able to enhance budget allocation decisions in the light of these other types of feedback. In complex marketing settings, traditional cost reports combined with other types of feedback may not be as diagnostic for enhancing resource allocation decisions as in simple settings (Briers *et al.*, 1999; Dearman and Shields, 2001). The value of CuPA in complex marketing settings is that it still provides accurate diagnostic information on the marketing support and profits of each customer needed to improve performance in complex settings.

While there are many types of complexity (Busemeyer *et al.*, 1986), our study varied the shape of the customers' profit functions by using two common types of sales response functions of the marketing literature (Mantrala *et al.*, 1992). Compared to traditional costing, results showed that CuPA reports enhanced budget allocations and resulting profitability only in a marketing setting with more complex profit functions. Further analyses suggested that participants with CuPA more efficiently used an iterative procedure (hill climbing) for optimizing budget allocations, and that they were better able to revise their initial over-investment of the marketing budget in a complex setting. The findings contrast with those of Gupta and King (1997) and should be seen in the light of an important methodological improvement to their study. In our experiment, the level of cost report accuracy did not decrease with the complexity of the environment and participants were issued updated cost reports after each trial.

LITERATURE REVIEW AND HYPOTHESIS BUILDING

Accounting Reports, Other Types of Feedback and Environmental Complexity

If a manager bases budget allocation decisions solely on accounting reports, then customer profitability reports are expected to have an edge on traditional costing reports, since revenue and marketing support differences across customers are more accurately reflected (Mulhern, 1999). This allows managers to gear their budgets efficiently to the more profitable types of customers. Nevertheless, marketing managers typically have, in addition to formal cost data, access to other types of feedback via their past decisions and interactions with customers (Bruns and McKinnon, 1993).

Experimental evidence in a production context suggested that decision makers do not rely solely on their accounting reports (Gupta and King, 1997). Participants receiving biased, volume-based cost data could still improve decisions when *outcome feedback* was available in the form of past statements of financial performance (Briers *et al.*, 1997; Gupta and King, 1997). Performance in this group, however, remained lower than in a group receiving a more refined activity-based costing report, since participants continued to rely primarily on the biased accounting report. But recent evidence has raised doubts about the value of accurate cost data by formally focusing on other types of feedback, available in addition to outcome feedback. Briers *et al.* (1999) and Dearman and Shields (2001) showed that decision makers were able to realize efficient decision performance under volume based costing reports as long as other information, including that relating to the market, their past performance, the product's cost consumption patterns or their general experience with ABC, was available. These other sources of feedback allowed the manager to correct for biases in their product cost reports. Hence, performance improved significantly even under biased cost information.

These earlier studies mainly focused on simple product-related decisions. The question as to whether more accurate customer profitability analysis reports are useful in a marketing resource allocation task, even if managers have access to other information, remains unanswered (Foster and Young, 1997). We extend the previous research in two ways. First, while prior studies mainly used linear demand or cost functions, focus here is on an alternative and realistic non-linear sales response and cost environment. Second, and more important, while prior evidence postulated that more accurate costing is not always needed, since other contextual feedback helps the manager to alleviate the biases of traditional costing, we claim that the diagnosticity of such feedback is dependent on the complexity of the marketing environment.

In simple settings, traditional profitability reports may be effectively combined with other feedback to form a diagnostic input almost as accurate as a CuPA report in enhancing marketing budget allocation decisions. But it is also commonly assumed that decision performance decreases as the environment becomes more complex (McIntyre and Ryans, 1983; Busemeyer *et al.*, 1986; Bonner, 1994; Hirst *et al.*, 1999). Bonner (1994) and Brehmer (1980) argue that proper use of the other feedback becomes less likely in complex settings. Hence, the use of other information to address problems with biased profitability reports in more complex

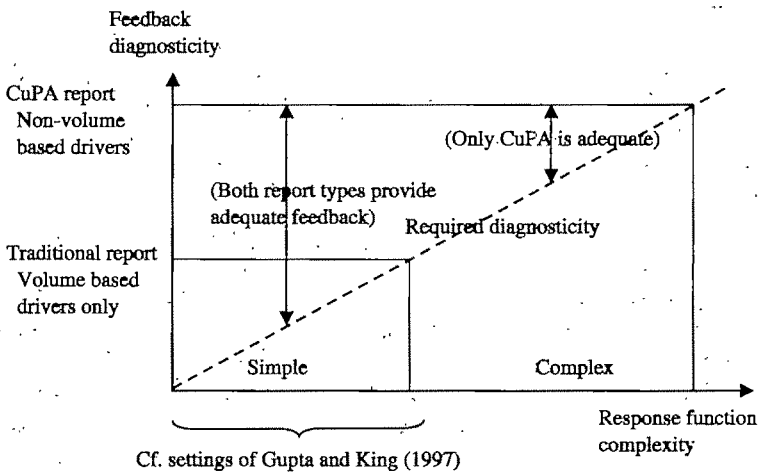
settings becomes less optimal and the diagnosticity of this input decreases (Feldman and Lynch, 1988). For improving performance in a complex setting, it is then important to have access to other relevant information (Busemeyer *et al.*, 1986). Since CuPA reports still provide relevant and accurate signals at the customer level (Iselin, 1996), it might still constitute a reasonable diagnostic input for improving performance in a more complex setting. In sum, the value of CuPA reports for resource allocation decisions is expected to increase in a more complex marketing setting. In such a setting, the diagnosticity obtained by combining other feedback with traditional profitability reports decreases *vis-à-vis* that of a more accurate CuPA report. Consequently, a CuPA report should have more value.

The present study's theoretical background is summarized by Figure 1. We study sales budget allocations that directly affect profits on a set of three heterogeneous customers. While there are many sources of complexity (Busemeyer *et al.*, 1986; Bonner, 1994), the complexity of the marketing environment is manipulated by varying the shape of the customers' profit functions via two common types of 'non-linear' sales response functions (Mantrala *et al.*, 1992). This created a simple versus a more complex profit environment (see description of the experiment). Whereas in simple settings both traditional and CuPA reports can be diagnostic, only non-volume driven CuPA reports may be adequate for enhancing budget allocations and profitability in a complex setting.

Only Gupta and King (1997) seem to have previously examined the benefits of more accurate activity-based costing reports in a complex production context. They did not find evidence for the higher value of ABC as opposed to volume-based costing in a complex setting. A complex setting in their study was typified by greater diversity in resource usage among products, but it still relied on fairly

FIGURE 1

THEORETICAL BACKGROUND OF THE PRESENT STUDY



simple linear functions.¹ Hence they might still have been operating on the low end of the complexity continuum, as indicated by Figure 1. This, in turn, may have obscured the interactive effect of ABC having more value in a complex setting. Moreover, the current scenario also introduced important methodological improvements to their setting. While Gupta and King (1997) only issued a cost report at the start of the experiment, we issued updated profitability reports after each new budget allocation and also held constant the degree of cost report accuracy across environments. In Gupta and King (1997), the accuracy of ABC decreased in a complex environment. Problems with accuracy, and the fact that ABC was only displayed once, most likely led participants to perceive this feedback as not sufficiently diagnostic for enhancing performance in a complex setting (Feldman and Lynch, 1988). This arguably further diluted the value-enhancing effect of ABC in complex environments in their study.

Hypothesis Tested

Participants performed a budget allocation task on three customers in either a simple or a more complex marketing context. In addition, they received a profitability report based either on traditional volume drivers or on the more accurate activity drivers of a CuPA report. The additional feedback consisted of *general prior descriptions* of the differences in revenue and marketing support among customers and *general outcome feedback* of past decisions. Our first hypothesis is concerned with main effects. Prior studies found that cost system accuracy affected the quality of output or product cost forecast decisions and resulting profits (Briers *et al.*, 1997; Gupta and King, 1997). Whether those results can be extended to resource allocation tasks is tested. In addition, we test whether the common assumption that realized decision performance decreases at higher levels of complexity holds for complex marketing settings (Bonner, 1994):

- H1a: Resource allocation decisions and resulting profit performance improve when the profitability report is more accurate (more accurate CuPA report using ABC versus a traditional cost report).
- H1b: Resource allocation decisions and resulting profit performance are negatively influenced by the complexity of the marketing environment.

Our second and main hypothesis concerns the interaction between cost report accuracy and complexity of the market setting. In a complex marketing scenario, other information in the form of simple outcome feedback and general descriptions of the customers' resource consumption is less diagnostic for addressing problems with volume-based cost reports, while CuPA still provides diagnostic profit information on customers. Consequently, the value of a more accurate CuPA report, versus a volume-based costing report, should increase in a complex marketing setting:

¹ In Gupta and King (1997), complexity was in fact manipulated in the following manner. The simple environment was a setting in which products used the same proportional resources (relative to the total resources used) for each defined activity. In the complex setting, products were more heterogeneous in the sense that they did not use the same proportion of resources in each defined activity. Both environments still used simple linear demand and cost functions. Conversely, we introduce non-linear functions in both settings and focus on the shape of the objective function as the source of complexity.

- H2: The performance benefits of CuPA reports versus traditional volume-based profit reports are more pronounced in a complex marketing environment when compared with a simple marketing environment.

EXPERIMENT

Experimental Design

The experiment uses a 2 x 2 design. The first factor is the type of profitability report with two levels of cost accuracy. Compared with a traditional report using a single volume cost driver, a CuPA report based on ABC better approximated actual profit differences across customers. The second factor is environmental complexity. Participants were assigned to either a simple or a more complex marketing environment. Complexity was manipulated by varying the shape of the sales response functions (functions linking sales budgets to realized demand), as shape is an important reason for differences in complexity (Busemeyer *et al.*, 1986; Bonner, 1994). Common S-shaped or concave sales response functions from marketing modelling were used to this end (Little, 1970; Lodish, 1971; Arndt and Simon, 1980; McIntyre and Ryans, 1983; Mantrala *et al.*, 1992).

Next, we describe the underlying functions of our two marketing environments, before explaining differences in complexity. Such descriptions are important in grasping how profitability reports, based on either CuPA or traditional costing, differ in the degree of accurate reflection of these underlying functions. The following two sections will then further explain the factors 'complexity' and 'type of profitability report'.

The Two Experimental Marketing Environments

Participants were asked to improve a firm's profits by allocating a sales visit budget to a set of three heterogeneous customers, A, B and C. In each environment, sales visits generated revenues. To create two environments that differ in functional shape, Panel A of Table 1 uses either a concave or an S-shaped sales response function to model the revenue response to an allocated sales budget. The parameter k_i , which represented incremental revenue, created variations in revenue potential across customers. More revenues could be realized for customer B than for customers C and A.

Panel B of Table 1 shows that customers are heterogeneous in their consumption of various marketing support functions (Foster *et al.*, 1996). First, if more sales visits are allocated to a customer, total visit cost (TVC) will rise for that customer since a sales visit is accomplished at a fixed price P . Second, variations in cost-to-serve were further introduced in two other support functions (Khumawala and Kelly, 1974; Klinecicz, 1990), particularly total delivery costs (TDC) and total logistic costs (TLC). It is important to note that these expenses are defined as non-linear functions of revenues. The power $q = 1/2$ was introduced (Panel B of Table 1), since our intention was to create settings in which required marketing support does *not* proportionally increase with revenues. Such settings bring about important cost advantages in terms of delivering customers with large revenue potential such as customer B, since they incur proportionally fewer costs than customers A and C. Non-volume cost drivers will then better capture this cost

TABLE 1

FUNCTIONS AND PARAMETER VALUES FOR THE TWO ENVIRONMENTS

Panel A: Total revenue function (TR) and parameter values (i = customer A, B, C)

Concave			S-shaped				
$TR_i = k_i[1 - \exp(-\beta_i x_i)]$			$TR_i = \lambda_i + k_i[x_i^{\mu_i}/(x_i^{\mu_i} + \rho_i)]$				
x_i = number of sales visit hours; k_i = potential revenues; β_i = responsiveness parameter,			x_i, k_i = see concave function; λ_i = revenues realized without effort, μ_i, ρ_i = responsiveness parameters,				
Parameters	k	β	Parameters	λ	k	μ	ρ
Cust. A	5,000,000	0.0900	Cust. A	750,000	4,250,000	3.00	2000
Cust. B	15,000,000	0.0254	Cust. B	1,000,000	14,000,000	2.90	34,200
Cust. C	11,000,000	0.0380	Cust. C	500,000	10,500,000	2.19	1200

Panel B: Cost functions and parameter values (same for concave as for S-shaped)

Total visit cost (TVC):	$TVC_i = px_i$
Total delivery cost (TDC):	$TDC_i = (w_1 TR_i)^q + w_2 TR_i$
Total logistic cost (TLC):	$TLC_i = (w_3 TR_i)^q$
Total production cost (TPC):	$TPC_i = m TR_i$

p = cost of a sales visit hour; w_1, w_2, w_3 = warehouse parameters;
 q = degree of concaveness; m = fixed margin;
Parameters: $P = 40,000$, $w_1 = 110,000$, $w_2 = 0.01$, $w_3 = 50,000$, $q = 1/2$, $m = 0.5$

heterogeneity among customers than the typical volume drivers (e.g., sales volume) used in traditional costing. Due to our primary focus on marketing costs, production costs (TPC) were defined as a fixed proportion of revenues.

The subject's task was to maximize profits by reallocating the sales visit budget. Panel A of Figure 2 shows that the number of sales visit hours invested in a customer directly affects customer profits. Since there are cost advantages in serving large customers, the optimal profit level for customer B is higher than for customers A and C.² Panel B of Figure 2 compares the S-shaped and the concave setting for the large customer. As can be seen, the shape of the profit function differs across environments. The difference in complexity between the two shapes is the subject of the next section.

The Complexity of the Marketing Environment

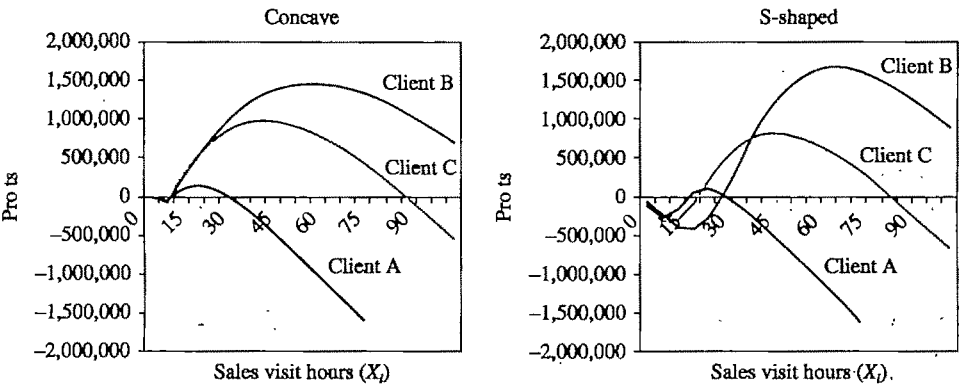
There are actually two arguments for assuming that concave profit functions constitute a markedly more complex marketing environment than S-shaped profit

² The optimal allocation in the simple (complex) environment was 19.24 (15.10) hours for customer A, 61.70 (52.32) hours for customer B and 42.26 (37.22) hours for customer C, which resulted in a total realized profit of 2602415 (2602705).

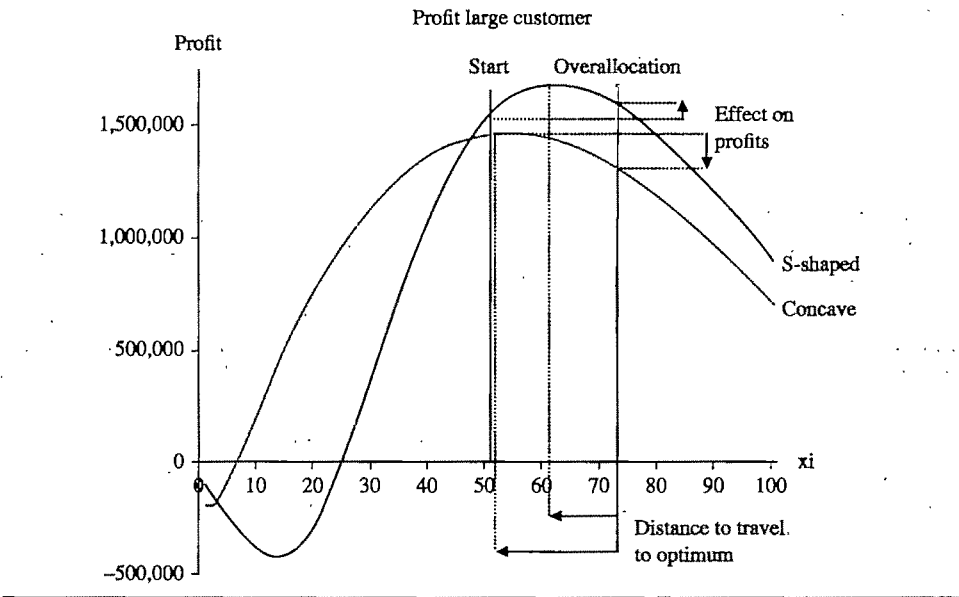
FIGURE 2

THE PROFIT OBJECTIVE FUNCTIONS

Panel A: Profit objective functions in both marketing settings



Panel B: Comparing S-shaped and concave profit functions for the large customer B



functions. The complexity is primarily due to the different slopes of the customers' profit functions, which are flatter for the concave marketing setting when compared to the S-shaped setting (see Panel B of Figure 2). Both decision making research (Busemeyer *et al.*, 1986) and accounting research (Bonner, 1994) suggest

that flatter functions are more difficult to learn. In turn, the slope of the customers' profit functions affects the diagnosticity of total outcome feedback. If these profit functions are steep, it is easier to infer the relationship between budget allocations (input) and their total outcome (Bonner, 1994), and the more visible the (negative) effects of faulty allocations are on total outcomes. Even if the decision maker receives biased profit data, total outcome feedback in combination with general customer descriptions can be diagnostic in correcting and guiding the decision maker's budget allocation decisions, and a more accurate CuPA report has less value. If, however, the customers' profit functions are flatter, it is more difficult to infer the effects of budgets (allocated to customers) on total outcomes (Bonner, 1994). The outcome feedback and the general customer descriptions are then less diagnostic for correcting and guiding budget allocation decisions under a biased profitability report. CuPA reports are expected to be more beneficial, since they still provide the relevant and accurate profit data for each specific customer (Busemeyer *et al.*, 1986) that are needed to improve performance in this more complex setting.

In addition to the slope of the profit function as the main factor of complexity, the participants' tendency to over-allocate a given starting budget added to the complexity of the concave setting.³ Apparently, participants believe, similarly to managers in real life (e.g., Ackoff and Emshoff, 1975), that it is better to allocate more resources. Panel B of Figure 2 shows that significantly over-allocating resources for a large customer may still lead to profit improvement in an S-shaped environment, whereas in a concave setting such behaviour negatively affects performance (see vertical arrows in the figure). Horizontal arrows further indicate that the distance to the optimum point becomes much larger in a concave than in an S-shaped setting. In order to improve performance, participants acting in a concave marketing environment were therefore required to reduce their initial belief in over-allocation to a greater extent. This made the concave setting even more complex because large revisions of an initial belief are known as difficult (Brehmer, 1980). An accurate CuPA report may then add value by better unmasking the negative effects of over-allocation in a complex setting. It allows participants to better revise their initially formed allocation rules (Sprinkle, 2000).⁴

³ The given starting values for the three customers were set at fifty-two sales visit hours per customer (total = 156). In all experimental conditions, similar patterns of over-allocation were manifest (e.g., the average budget allocated to the large customer B in trial one was 80.32). Panel B of Table 4 of the result section provides further evidence of over-allocation.

⁴ There is a possible counter argument with respect to the complexity of the environment. When comparing the starting hours (52 hours for each customer) with the optimal solution reported in note 2, finding the optimal state in a concave setting requires a uniform reduction (customer A and C) or a no change (customer B) of allocation when compared with the starting point. In the S-shaped setting, both increases (customer B) and decreases (customers A and C) to the budget with respect to the starting point are needed to improve profits. Uniformly reducing or not changing a budget (concave setting) might be easier to infer, possibly reducing the level of complexity in the concave setting. Most likely, such an alternative interpretation can be ruled out, because participants largely over-allocate their budget in both the concave and S-shaped environment. The consequence of over-allocation is that the distance to achieving the optimum becomes much greater in a complex setting when compared with a simple setting, making the concave setting even more complex.

The Type of Profitability Report

Participants did not receive the actual customer data based on the functions and parameters of Table 1. Instead, either a traditional profitability report or a more accurate CuPA report based on ABC was issued, in addition to the available outcome feedback and the descriptions of the customers' purchase behaviour. Panels A and B of Table A2 (Appendix) display both types of profitability reports for the initial starting situation.

The traditional report gathered all the typical marketing expenses (sales visit, delivery and logistic costs) into a single cost pool that was then assigned via revenues as a single cost driver (Johnson and Kaplan, 1991). Costs are misallocated since this driver assumes a volume relationship between revenues and marketing expenses (Selnes, 1992). Any cost advantages in delivering a large customer are ignored (see cost function of Table 1). In Table 2, customers under traditional costing are shown as equally profitable at the margin, which is far from an accurate reflection of the actual margins.

In a CuPA report, the total of each marketing cost was allocated to customers via activity drivers. For sales visiting, the CuPA report used the number of sales visit hours as an activity driver. Hence, allocated costs were similar to the actual cost setting. For the delivery and logistic costs, the number of deliveries and stock pickings were used as activity drivers based on the assumptions of Panel C of Table A2 (Appendix A). These drivers were derived by the experimenter such that the large customer required fewer deliveries and stock pickings than the smaller customers A and C. Hence, customer B is assigned less cost in proportion to demand (non-volume relation), which corresponds to the actual cost function of Table 1. Table 2 shows that profit margins under CuPA are a more accurate reflection of the actual profit margins. There is, however, still a small error, since a non-linear cost function is approximated by locally linear functions of their activity drivers (Christensen and Demski, 1995).

As for the cost report, the methodological improvements to Gupta and King (1997) were twofold. First, instead of issuing cost data only once, updates of the cost reports of the Appendix were provided after each decision. In the case of CuPA, the report also contained updated data on the number of deliveries and stock pickings and their driver rates.⁵ Second, in Gupta and King's setting (1997), accurate cost data were more accurate for three products in a simple environment when compared to traditional costing, while in the complex setting this was only the case for two products. We argue that as the level of accuracy of a more refined cost report does not vary across environments, the internal validity of the experiment is increased. Table 2 shows that CuPA indeed produced the most accurate profit figures for all three customers in both our simple and complex marketing setting. Due to our improvements, participants were more likely to perceive the

⁵ Cost information and driver rates were updated after each period because driver rates for the delivery and logistic costs varied as the allocation of sales visits changed. This implied that logistic and delivery expenditures were variable to a certain extent. In fact, they were defined as non-linear functions of volume (see Table 1). This is a somewhat realistic assumption, since practitioners often refer to marketing expenditures as semi-variable costs (Kaplan and Atkinson, 1998).

TABLE 2

TRUE VS COST REPORTS' MARGINS AT THE START OF THE EXPERIMENT

(Start allocation: 52 sales visit hours for each customer)

	Profit margins in complex setting (%)			Profit margins in simple setting (%)		
	True	Trad.	CuPA	True	Trad.	CuPA
Customer A	-17.94	5.63	-20.50	-18.08	5.62	-20.68
Customer B	13.34	5.63	15.33	14.04	5.62	15.77
Customer C	9.01	5.63	8.04	8.02	5.62	7.29
Total	5.63	5.63	5.63	5.62	5.62	5.62

accurate cost reports to be more diagnostic in a complex environment than participants in the study of Gupta and King (1997).

Experimental Procedures

Participants were recruited from a master's course in management accounting at a large western European university. The course had dealt with traditional accounting methods, ABC and customer profitability analysis before the experiment took place. A total of 139 students completed the task on a computer. They were randomly assigned one of the four experimental conditions.⁶ Sessions lasted one hour. To ensure motivation, participants were notified in advance that the four best players would each receive a €20 gift coupon.⁷ The experimental setting was introduced as a case study. Before commencing the task, participants reviewed computer screens describing a hypothetical company specializing in home protection systems (such as electronic shutter systems, fencing systems, fly screens) and their task.

First, all participants received descriptions of the company's customers to provide prior knowledge of customers' revenue and cost behaviour. Customer A was a self-employed carpenter ordering small quantities in different sizes and colours. Customer B was a building contractor with a large sales volume, ordering large quantities of the same sizes and colours. Customer C represented a home protection shop with a medium level and variety of sales. Second, participants also received outcome feedback and a formal customer profitability report on the initial starting

⁶ In the simple (complex) marketing environment, 37 (35) participants received a CuPA report while 33 (34) others received a traditional profitability report. All participants were instructed to arrive ten minutes early for each session. However, random assignment was used to ensure that latecomers had an equal chance of being assigned to one of the four cells (Brownell, 1995). By using this principle, it is most unlikely that the latecomers had an effect on the reported results on motivation. In fact, overall motivation was very high (see analysis of self-perceived motivation below).

⁷ The best player in each of the four conditions was rewarded with a coupon. Average profit was taken as basis for the reward, in order to motivate people to perform well in every trial. McIntyre and Ryans (1983) used a similar reward scheme.

point in which the company allocated fifty-two hours to each customer. Reports were either based on traditional or CuPA assumptions, issued in a form as displayed in the Appendix. The instructions mentioned how the reports assigned typical marketing expenses. In the case of CuPA, detailed driver rate information was also available.

Importantly, participants did not receive any environmental parameters, nor were they informed of the level of complexity and the maximum profit that could be achieved in their environment. Instruction screens explicitly stated that sales visit budgets were needed to induce customer sales and that a maximum of 200 sales visit hours per period were available. They were also told that better allocations of the sales budget would provide ample room for profit improvement. After reading the instructions, participants performed the budget allocation task over ten periods. After each period, they received total profit feedback and an updated profitability report.

On completion of the task, participants filled out a post-test questionnaire with five-point scales checking for motivation, task understanding and their usage of cost reports. The 131 students who completed the questionnaire assigned a high score (average = 3.996; median = 4) to the item, 'I was very motivated to perform well on the task'. Further analysis revealed that participants in simple settings were slightly more motivated than those in complex settings ($F_{(1, 127)} = 3.78$; $p < .06$). Importantly, no differences were detected for cost report type ($F_{(1, 127)} = 1.23$; $p > 0.26$).

RESULTS

The Effect on Performance

In order to investigate the effect on performance we ran the regression of equation 1 with the relative deviation from optimal profit (% dev. π_n^*) as the dependent measure.⁸

$$\% \text{dev.} \pi_n^* = b_0 + b_1 R + b_2 E + b_3 RE + b_4 T + e \quad (1)$$

The lower the score on the dependent measure, the closer one is to optimal profit. This model contains the main effects of the type of cost report R (R is 1 for CuPA and 0 for traditional cost data) and the marketing environment E (E is 1 for simple and 0 for complex) to test H1a and H1b. It also includes their interaction (RE) to test our main hypothesis (H2) whether the value of more accurate CuPA reports depends on the complexity of the marketing environment. In addition, we expected decision makers to improve profits over time (Gupta and King, 1997). Therefore, cumulative experience reflected by the trial number T ($T = 1, 2, \dots, 10$) was added as a control variable. Often inherent in learning tasks is the presence

⁸ $\% \text{dev.} \pi_n^* = (\pi_n^* - \pi_n) / \pi_n^*$ where π_n^* is the optimal profit and π_n is the realized profit for each trial/participant observation ($n = 1,390$; 10 trials and 139 participants). At the start, the distance from optimal profit in the simple setting was 45.14 per cent whereas in the complex setting it was only 44.99 per cent. We therefore multiply the $\% \text{dev.} \pi_n^*$ in the simple condition by a factor of 0.9967 (= 44.99/45.14).

of non-constant variance of the error term (heteroscedasticity). White's (1980) test for heteroscedasticity concluded that our error term of model (1) lacked constant variance. Due to the participants' built-up experience, its variance decreased over trials (T). The weighted least squares method,⁹ to correct for non-constant variance (Neter *et al.*, 1996), was used to estimate the coefficients of the model. Results are presented in the first model (full model) of Panel A of Table 3; White's test did not detect any presence of heteroscedasticity.

The control variable (T) is significant in the full model (see Panel A of Table 3), confirming that participants are able to improve profit performance, irrespective of the marketing environment and the type of profitability report (Gupta and King, 1997).

The coefficient for the type of profitability report is significant supporting H1a, with CuPA reports resulting in better profit performance than traditional profitability reports. This is in line with prior findings of cost report accuracy (Briers *et al.*, 1997).

Hypothesis H1b that stated that profits decreased with the complexity of the marketing environment is supported (Panel A of Table 3). The significant effect of the environment indicates that profits are closer to the optimum in a simple setting than in a more complex one, implying that profit improvement is more difficult to achieve in a complex marketing setting (Bonner, 1994).

Finally and more importantly, the significant positive interaction term in the full model shows that the effect of report type is sharply reduced in a simple marketing setting. This suggests that CuPA reports have more value in a complex marketing context, supporting our main hypothesis H2 that posited that the effects of CuPA are more pronounced in a complex marketing setting.

To examine the effect of report type (R) on profits in more detail, analyses were run *separately for each environment*. Results are reported in Models 2 and 3 of Panel A of Table 3. In the simple marketing environment (Model 2), CuPA reports had no significant benefit over traditional reports. In contrast, in the complex setting (Model 3), report type was significant, suggesting that CuPA has an edge on traditional costing only in a complex marketing setting (H2). The summary statistics of Panel B and the figures in Panel C reinforce this. In contrast to Gupta and King (1997), our results indicate that complexity of the marketing setting serves as an important contextual factor for CuPA reports to have incremental benefits on firm profitability.

We also conducted significance tests on the budgets allocated to each customer.¹⁰ Although profits were generally lower in the complex setting (H1b), participants with CuPA made more optimal budget allocations for the large customer ($p < .02$)

⁹ We used the square root of T as a weight, assuming that the variance of the error terms decreased with the trial number T .

¹⁰ For each trial/participant observation, we tested how far participants were removed from the optimal budget for each customer. The following WLS regression model for both the simple and complex environment was tested: $\%dev.X_{it}^* = b_0 + b_1 \text{ system} + b_2 \text{ trial}$ (with $\%dev.X_{it}^*$ = absolute deviation $(X_{it}^* - X_{it})/X_{it}^*$; and X_{it}^* is the optimal budget for customer i ; and X_{it} is the budget allocated to a customer i (= A, B and C).

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TABLE 3

THE EFFECT ON PROFIT PERFORMANCE

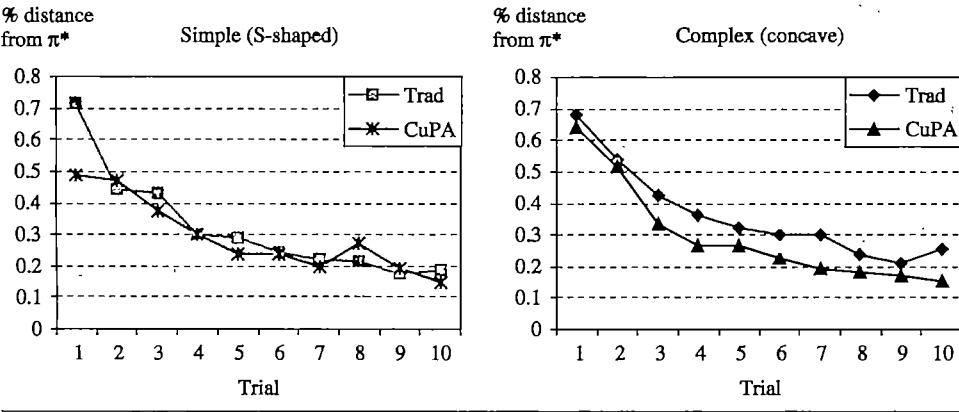
Panel A: WLS regression results on the dependent variable % dev. π^* for the full model (1) and the reduced models analysed by environment (models 2 and 3)

Variable	Model 1 Full model (<i>n</i> = 1390)		Model 2 Subset simple (<i>n</i> = 700)		Model 3 Subset complex (<i>n</i> = 690)	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	0.5618	0.0001	0.5076	0.0001	0.5701	0.0001
Report (<i>R</i>)	−0.0714	0.0002	−0.0165	0.3888	−0.0714	0.0002
Environment (<i>E</i>)	−0.0460	0.0188	—	—	—	—
Interaction (<i>RE</i>)	0.0549	0.0434	—	—	—	—
Trial (<i>T</i>)	−0.0375	0.0001	−0.0362	0.0001	−0.0388	0.0001
Adjusted <i>R</i> ²	0.1435		0.1282		0.1567	
<i>p</i> -value model		0.0001		0.0001		0.0001

Panel B: Average mean statistics (of all 10 trials) per experimental cell

	Simple		Complex	
	Traditional	CuPA	Traditional	CuPA
Participants (<i>n</i>)	33	37	34	35
Mean % dev. π^*	32.20%	29.25%	36.37%	29.54%
Difference Trad/CuPA	2.95%		6.83%	

Panel C: Trial by trial % distance to optimal π^* for the report types analysed by environment



and the small customer ($p < .01$) than those using traditional reports. In the simple environment, report type was not significant at the 5 per cent level for any of the customers. It appears that outcome feedback and general customer descriptions in the simple setting allowed participants with biased profit data to develop allocation strategies similar to those made under CuPA, while the use of this feedback was less diagnostic in the more complex marketing setting. In the latter setting, participants with CuPA reports developed more profitable budget allocations compared to their volume-based costing counterparts. Additionally, the exit questionnaire checked the participants' perceived use of accounting information. In the complex setting, participants with CuPA reports found the cost report more relevant since they assigned a higher score to the item, 'In my opinion, the cost reports were relevant for the allocation decision' than participants with traditional costing ($F_{(1, 64)} = 4.10$; $p < .05$). In the simple setting, the relevance of the cost report did not differ across accounting report type ($F_{(1, 64)} = 2.10$; $p > .15$), indicating that traditional information, combined with other feedback, still provided a relevant tool for profit improvement. In sum, the various analyses confirm that the value of CuPA reports increases with the complexity of the marketing environment (H2).

Supplementary Analysis on the Role of Accounting Information

Further analyses were performed to *understand why* a more accurate CuPA report had value only in a complex marketing setting. First, the extent to which individual budget allocations followed an iterative procedure for maximizing profits was tested. When faced with a resource allocation task, psychological literature argues that participants can use such an iterative procedure labelled as 'hill climbing' (Stevenson *et al.*, 1990). Whenever a decision increases profits (uphill move), the procedure prescribes that subjects should continue to adjust their decisions in the same direction as the previous trial. If profits decrease after a decision (downhill move), decisions should be adjusted in the opposite direction of the previous trial, to reverse the negative trend.

While prior accounting literature provided descriptive evidence of the use of this principle in output and product cost forecast decisions (Dickhaut and Lere, 1983; Turner and Hilton, 1989; Gupta and King, 1997), our study is the first to test explicitly whether the fine-tuning of budget allocations for individual customers in fact *differs across cost report type*. In a simple environment, informative outcome feedback may efficiently guide the decision maker's budget adjustments and cost system choice may be less relevant. However, as outcome feedback is less informative in a complex setting, the CuPA report can provide accurate profit feedback on customers that better assists the decision maker to apply (fine-tune) hill climbing to each single customer.

For each trial ($T = 1, 2, \dots, 9$)¹¹ and customer within that trial we checked whether budget adjustments were consistent with hill climbing. Whenever actual customer *profits increased*, we coded hill climbing as used if the budget adjustment

¹¹ We lose the observation for the final trial 10. Although it is possible to test if profits had increased or decreased in trial 10, one cannot observe the direction participants would choose for the next trial. In total, 1,251 observations were used in the analysis (nine trials for each of the 139 participants).

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in the next trial continued in the same direction as the previous one; for example, if the profit increase was realized with a budget increase, then participants should continue to increase the budget in the next trial. If subjects changed direction after a profit increase, hill climbing was not used. Whenever customer *profits decreased*, hill climbing was used if the budget adjustment in the next trial changed direction; for example, if the profit decrease was due to a budget increase, participants should reverse the trend by decreasing the budget in the next trial. If, however, they continued in the same direction, hill climbing was not used. To be conservative, we coded adjustments as fine-tuned with hill climbing ($HC = 1$) if it was reflected in the budgets of all three customers. Otherwise, it was not fine-tuned ($HC = 0$). In order to test if the fine-tuning of this principle depended on report type (R), the following logistic regression was run for each marketing environment separately:

$$HC = b_0 + b_1R + e \quad (2)$$

Panel A of Table 4 shows the results of this first supplementary analysis. The model is only significant in the complex marketing environment. If participants were provided with a CuPA report, budget allocation decisions were more likely to be consistent with hill climbing. We expected that whenever hill climbing was

TABLE 4
SUPPLEMENTARY ANALYSES

Panel A: Logistic regression results for the model $HC = b_0 + b_1R + e$											
	Simple subset ($n = 630$)		Complex subset ($n = 621$)								
	Estimate	p -value	Estimate	p -value							
Intercept	-2.4776	0.0001	-2.3767	0.0001							
Report (R)	0.2704	0.3414	0.5588	0.0327							
χ^2 model	0.915		4.698								
p -value model		0.3387		0.0302							
Panel B: Trial by trial mean of the <i>total</i> sales visit budget (= A + B + C)*											
	T1	T2	T3	T4	T5	T6	T7	T8	T9	T10	T10-T1
Simple											
Trad	184.6	174.7	168.6	159.0	153.8	147.4	146.4	145	139.9	140.7	43.9
CuPA	176.6	165.4	150.6	149.0	140.8	138.4	138.3	132.0	130.3	133.1	43.5
Complex											
Trad	177.2	160.3	152.7	146.1	141.1	136.8	139.3	130.5	129.0	132.5	44.7
CuPA	178.9	163.1	145.5	139.1	122.6	129.2	126.4	122.6	122.7	123.0	55.9

* Note that participants always allocate more sales budgets than needed since the optimal total budget was 123 in the *simple* setting and 105 in the *complex* setting.

fine-tuned during a certain trial, profits realized in the next trial would be higher. The model that tested whether the profits realized in the next trial were predicted by *HC* was indeed statistically significant ($F_{(1, 1249)} = 16.39$; $p < .01$). We can conclude that the enhanced value of CuPA in the complex environment stems from budget allocations following this iterative adjusting principle to a greater extent, which in turn positively affects profit performance.

A second supplementary analysis is reported in Panel B of Table 4. It tests whether accurate cost reports allow for better reduction of initial over-allocation behaviour in complex settings. Although such behaviour is present in every cell (Panel B), it led to larger profit decreases in a complex marketing setting when compared to a simple setting. As discussed in the experimental setting, over-allocation should be reduced more in complex settings if participants want to improve performance. Results indeed show a reduction of fifty-six hours between the first and the last trial for the complex setting with CuPA. This is much higher than in the other cells. Together, the results suggest a belief revision role for CuPA in complex marketing settings (Sprinkle, 2000). Through the use of more accurate data, participants better revised the appropriateness of their initially formed allocation rules in complex settings (e.g., over-allocate a sales budget).

DISCUSSION

This article provides evidence that the benefits of more accurate customer profitability reports for marketing resource allocation decisions increase with the complexity of the marketing environment. Moreover, only in a complex marketing setting did we detect an effect of cost report type on profit performance, while in a simple setting such an effect was absent. In simple settings, combining other data such as outcome feedback and prior descriptions of a customer's cost behaviour with traditional costing already constitutes a diagnostic tool as effective as a more accurate CuPA report. In a more complex setting, performance generally decreased. Especially here, combining other feedback with volume-based costing is difficult and the diagnosticity of such input decreases. Conversely, CuPA reports still provide diagnostic information on revenue and marketing support variations across customers in these complex settings, and their benefit increases when compared to a volume-based costing report.

In contrast to Gupta and King (1997), we find support for the important interaction between complexity as a contextual factor and cost report accuracy. Our results should be seen in view of increased internal validity as a result of important methodological improvements compared to that earlier study. For decision makers to consider CuPA reports relevant in a complex setting, we think it is important to maintain the same degree of cost report accuracy in a complex setting as in a simple one. In addition, as in real life, our setting provided regular updates of the profitability report after each allocation decision. Of particular interest is the fact that the typical non-volume drivers and the driver rates in our CuPA report were also updated after a change in allocation in each period, since certain marketing expenditures were defined as semi-variable overheads. Driver

rates in our setting were in fact calculated on the basis of practical capacity since the overhead of each period was used. Future research may examine the impact of fixed driver rates by considering fixed marketing expenditures.

This article casts light on the role of more accurate cost data in complex marketing environments. It is the first to demonstrate that common procedures such as hill climbing for *optimizing resource allocations* are more efficient in the presence of more accurate cost data (e.g., CuPA) than under traditional volume-based costing. Additionally, in complex marketing settings, participants with CuPA better assessed the negative effects of over-investing their marketing resources and consequently such over-allocation behaviour was largely reduced. To conclude, by focusing on a resource allocation task we found that CuPA reports enable better learning in more complex marketing environments. In this way we extend prior work that only briefly discussed learning principles in pricing, output and product cost decisions, without an explicit focus on the effects of various cost reports on learning (Dickhaut and Lere, 1983; Gupta and King, 1997). In fact, it is shown that there is a strong need for explicit tests of how cost reports and contextual factors interact with learning in these crucial accounting tasks.

Complexity can take many different forms. Our experiment induced complexity by creating flatter profit functions via common types of sales response functions of the marketing literature. This manipulation is an important component of actual experienced complexity in a marketing scenario, but still it is just one source of complexity. Accounting researchers often describe a complex business as a firm interacting with many diverse customers, heterogeneous in their cost behaviour. Besides cost and customer diversity, it is also suggested that marketing managers often face simultaneous decisions regarding each customer account (e.g., problems concerning discounts and customer pricing, distribution arrangements) that can add to complexity. When more complexity factors are combined, it is even more difficult for managers to come up with a solution (Campbell, 1988; Bonner, 1994). Whether more accurate cost data can continue to provide diagnostic information to the decision maker at these growing levels of complexity remains a subject for future inquiry.

These are only a few of the interesting avenues for further experimental research to assess the benefits of different accounting systems, and to test under which circumstances they hold. In real life, benefits from cost accuracy should obviously be weighed against their implementation costs and against other types of feedback. In any event, further progress requires a change of focus from *whether* ABC systems have beneficial effects to *when* and especially *how* and *why* these effects are obtained. This will allow us to build an adequate theory, which in turn can guide pragmatic advice to the business community.

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APPENDIX

This appendix displays the different kind of profitability reports of the starting situation, where fifty-two hours to each customer are allocated. Figures are only shown for the complex marketing environment; analysis for the simple setting is similar. Table A1 displays the actual figures at the start. It is important to note that participants do not receive the actual cost figures but receive either a traditional profitability report as shown in Panel A of Table A2, or a CuPA report using ABC as shown in Panel B of Table A2. In addition, these reports are also updated as participants reallocate their sales visit budget.

TABLE A1
ACTUAL MARKETING ENVIRONMENT (CONCAVE RESPONSE FUNCTIONS)

	Cust. A	Margin (%)	Cust. B	Margin (%)	Cust. C	Margin (%)	Total	Margin (%)
X_i	52		52		52		156	
TR	4,953,605		10,996,175		9,475,151		25,424,931	
TPC	2,476,802	50.00	5,468,087	50.00	4,737,576	50.00	12,712,465	50.00
Cust. cost	3,365,382	67.94	4,031,261	36.66	3,883,967	40.99	11,280,610	44.37
TVC	2,080,000	41.99	2,080,000	18.92	2,080,000	21.95	6,240,000	24.54
TDC	787,707	15.90	1,209,770	11.00	1,115,665	11.77	3,113,144	12.24
TLC	497,675	10.05	741,491	6.74	688,301	7.26	1,927,466	7.58
Profit (π)	-888,580	-17.94	1,466,826	13.34	853,609	9.01	1,431,856	5.63

ABACUS

TABLE A2

A TRADITIONAL VOLUME BASED COSTING REPORT VS A CuPA REPORT

	Cust. A	Margin (%)	Cust. B	Margin (%)	Cust. C	Margin (%)	Total	Margin (%)
Panel A: Traditional cost report using revenues as volume driver								
Revenue	4,953,605		10,996,175		9,475,151		25,424,931	
Production cost	2,476,802	50.00	5,498,087	50.00	4,737,576	50.00	12,712,465	50.00
Customer cost	2,197,830	44.37	4,878,816	44.37	4,203,964	44.37	11,280,610	44.37
Profit	278,973	5.63	619,272	5.63	533,611	5.63	1,431,856	5.63
Panel B: CuPA profitability report using ABC cost drivers								
Revenue	4,953,605		10,996,175		9,475,151		25,424,931	
Production cost	2,476,802	50.00	5,498,087	50.00	4,737,576	50.00	12,712,465	50.00
Customer cost	3,491,972	70.50	3,812,906	34.67	3,975,733	41.96	11,280,610	44.37
<i>Driver</i>	<i>rate</i>	<i>#</i>	<i>Cust. Cost</i>	<i>#</i>	<i>Cust. Cost</i>	<i>#</i>	<i>Cust. Cost</i>	<i>#</i>
<i>Visit</i>	<i>40,000</i>	<i>52</i>	<i>2,080,000</i>	<i>52</i>	<i>2,080,000</i>	<i>52</i>	<i>2,080,000</i>	<i>156</i>
<i>Delivery</i>	<i>4,111</i>	<i>198</i>	<i>814,537</i>	<i>275</i>	<i>1,130,086</i>	<i>284</i>	<i>1,168,522</i>	<i>757</i>
<i>Logistics</i>	<i>10,964</i>	<i>545</i>	<i>597,435</i>	<i>550</i>	<i>602,820</i>	<i>663</i>	<i>727,211</i>	<i>1,758</i>
Profit	-1,015,169	-20.5	1,685,182	15.33	761,843	8.04	1431,856	5.63
Panel C: Cost driver assumptions of a CuPA report (not shown to participants)								
			<i>Deliveries per 100,000 revenues</i>				<i>Stock pickings per 100,000 revenues</i>	
<i>Customer A (small)</i>			<i>4</i>				<i>11</i>	
<i>Customer B (large)</i>			<i>2.5</i>				<i>5</i>	
<i>Customer C (medium)</i>			<i>3</i>				<i>7</i>	

* The number of sales visits, deliveries and stock pickings.

Panel A of Table A2 displays a traditional profitability report. It uses total revenues as a driver to assign total customer costs (= 11,280,610, Table A1) to customers. Conversely, the CuPA report uses activity drivers to allocate the total of visiting, delivery and logistic costs to customers. Panel B of Table A2 shows that the allocation of sales visit cost is comparable with actual cost data, since sales visit hours are used as cost drivers. Total delivery and logistic costs are allocated on the basis of the assumptions of Panel C of Table A2, with customer B actually using fewer deliveries and stock pickings. Due to these assumptions, a CuPA report (Panel B of Table A2) is much closer to actual cost data (Table A1) than traditional volume-based costing (Panel A of Table A2).

Notes of the University of Sydney Pacioli Society

THE UNIVERSITY OF SYDNEY PACIOLI SOCIETY MEETING, 14 OCTOBER 2003

CORPORATE GROUPS—COMPLEXITY AND REFORMS IN ACCOUNTING AND THE LAW

This brief talk will introduce the topic to be covered in more depth by Justice Neville Owen.¹ It is indeed a great privilege to have Justice Owen address the Pacioli Society. This is the type of 'town and gown' engagement that the founder of the society, Ray Chambers, envisaged when he formed Pacioli over four decades ago (see *Abacus*, February 2003, for details of the society's formation)—an accomplished speaker, an informed audience, and good food and drink.

Catalyst

Tonight's dinner/meeting of the Pacioli Society emerged from a submission by Professors Peter Wolnizer, Frank Clarke and myself to the HIH Royal Commission in mid-2002. Subsequently the Royal Commissioner sought a private hearing to clarify matters raised in that submission. The submission argued that it was a *prius* for effective corporate governance to change the financial data presented in corporate financial statements. It also suggested that the complexity of transactions and structures of doing business involving corporate groups was a factor in the new millennium 'crisis' in business and accounting. Those concerns underpinned the lament in Clarke *et al.*'s *Corporate Collapse* (2003) that auditors are on a 'mission impossible' when auditing complex corporate structures and circuitous transactions presently employed by many companies. Numerous wire diagrams were provided in *Corporate Collapse* (see Appendix)—and these were supported by the evidence in Ramsay and Stapledon's (2001) analysis of the use of corporate groups in Australia.

Much earlier, in 1973, Chambers had captured the essence of the problem: 'Inter-company shareholdings and transactions have given cover to fraudulent dealings and to legally less serious but financially no less deceptive mis-statements of results and position'.

This observation followed analyses of Australian and overseas failures of the 1960s and early 1970s. It mirrored comments made in reports of official inquiries

¹ Unfortunately, Justice Owen was unable to attend the meeting.

into many of those failures—especially Reid Murray (Reports of Inspectors, *Final Report*, 1966), Stanhill's notorious *Round Robin* transaction (Report of Inspector, *Third and Final Report*, 1967), and Moffit J (in *Pacific Acceptance . . .*, 1970). All cases are discussed in Clarke *et al.*'s *Corporate Collapse* (2003). Moffit J observed difficulties in auditing corporate groups (especially forming an opinion about the group accounts) where separate auditors for the parent and subsidiary companies exist. Further, in the late 1970s inspectors inquiring into the collapse of Cambridge Credit Corporation Group had revealed problems auditing transactions between companies within the Cambridge Group and the private group of companies controlled by its founder. The concerns raised in *Corporate Collapse* are more pervasive, leading the authors to question the serviceability of conventionally prepared consolidated accounts and hence the usefulness of the audit of consolidated accounts.

Evidence adduced in preparation of the initial and the revised editions of *Corporate Collapse* (1997, 2003) revealed similar features to those in the 1960s and 1970s. Hence the observations of Chambers and others above were deemed equally applicable to the Minsec and Cambridge Credit sagas, and the Adsteam, Westmex and Bond Corporation affairs in the 1980s–90s, and to the HHH and One.Tel and (say) Enron affairs in the new millennium.

Evident in all of the *bon mots* is a tension between the separate legal entity and group (enterprise) principles at law. And asking whether the preparation of separate company and group accounts is more appropriate is a natural corollary. This tension was noted in CASAC's *Corporate Groups Final Report* (2000), and it underpinned the proposed reform to group accounting that was outlined in Clarke *et al.* (2002). That article drew on data underpinning Clarke *et al.* (2003) and prior group accounting reforms outlined in Chambers (1973) and the N.S.W. Government Accounting Standards Review Committee Report (1978). Today that tension is still evident in the Corporations and Markets Advisory Committee's Discussion Paper, *Rehabilitating Large and Complex Enterprises in Financial Difficulties* (September 2003). As an aside, the introduction in Australia in the mid-1980s of, first, the NCSC Deed of Indemnity, and then of the formalized ASIC Deed of Cross Guarantee, seems to have added another layer of tension (see Houghton *et al.*, 1999).

Significant issues in the HHH affair were highlighted during the private hearing requested by Justice Owen (I hope he does not mind me recounting this). Justice Owen had asked several questions seeking clarification of issues related to the assessment of 'solvency' within 'a corporate group setting'. He then turned the questioning to reforms, asking, 'If you were in my role as Royal Commissioner, how would you propose cutting through the complexity revealed in the HHRC hearings and submissions?' My response relied on what had been appositely remarked by the two lawyers appointed as inspectors into the failure of the Reid Murray Group of companies some four decades earlier: 'Neither of us is skilled in accountancy and . . . much . . . we have said [in the Reports] . . . will not be acceptable by the accounting profession generally. [We use] . . . commonsense, and commonsense has compelled us to reject a number of practices used in the group and apparently regarded as acceptable by accountants.'

Alfred North Whitehead (1929/1957, p. 110, as cited in Chambers, 1995) ably captures the importance of relying on 'commonsense': 'Science is rooted in . . . the whole apparatus of commonsense, you may contradict it in details, you may surprise it. But ultimately your whole task is to satisfy it.' The law related to corporate groups and the consolidation accounting for them seems to be a long way from meeting Whitehead's commonsense goal. If commonsense had prevailed after the spate of 1960 failures and reforms following the inevitable inquiries, then perhaps simplicity rather than complexity would be the norm in how corporates are allowed to structure their organizations. And the accounting for those groups would be more easily undertaken and understood by all interested parties—both 'inside' and 'outside' users. Clarke *et al.* (2002) sought to provide such a simplified approach. It will be interesting to hear tonight Justice Owen's position perhaps on these and related matters.

Graeme Dean, The University of Sydney

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ACRONYMS USED

- ASIC Australian Securities Investments Commission replaced the Australian Securities Commission (ASC) in 1998, which had replaced the National Companies and Securities Commission (NCSC) in 1991 as Australia's corporate regulator.
- HIHRC HIH Royal Commission, appointed in May 2001, it reported in April 2003.

CASES CITED

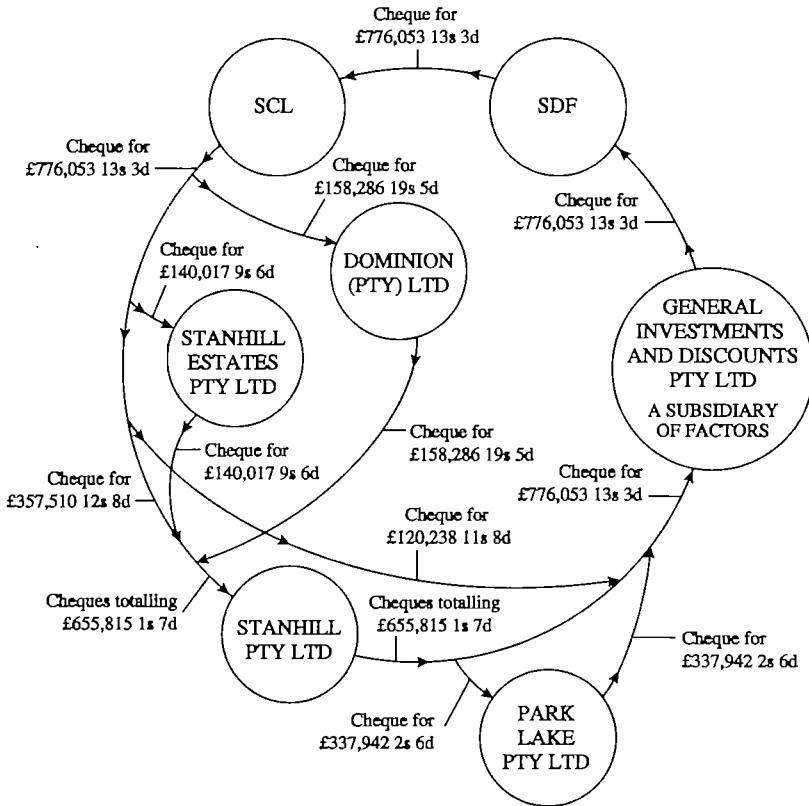
Pacific Acceptance, Cambridge Credit, Reid Murray, Stanhill

APPENDIX

COMPLEX CORPORATE STRUCTURES—WIRE DIAGRAMS
(taken from Clarke *et al.*, 2003)

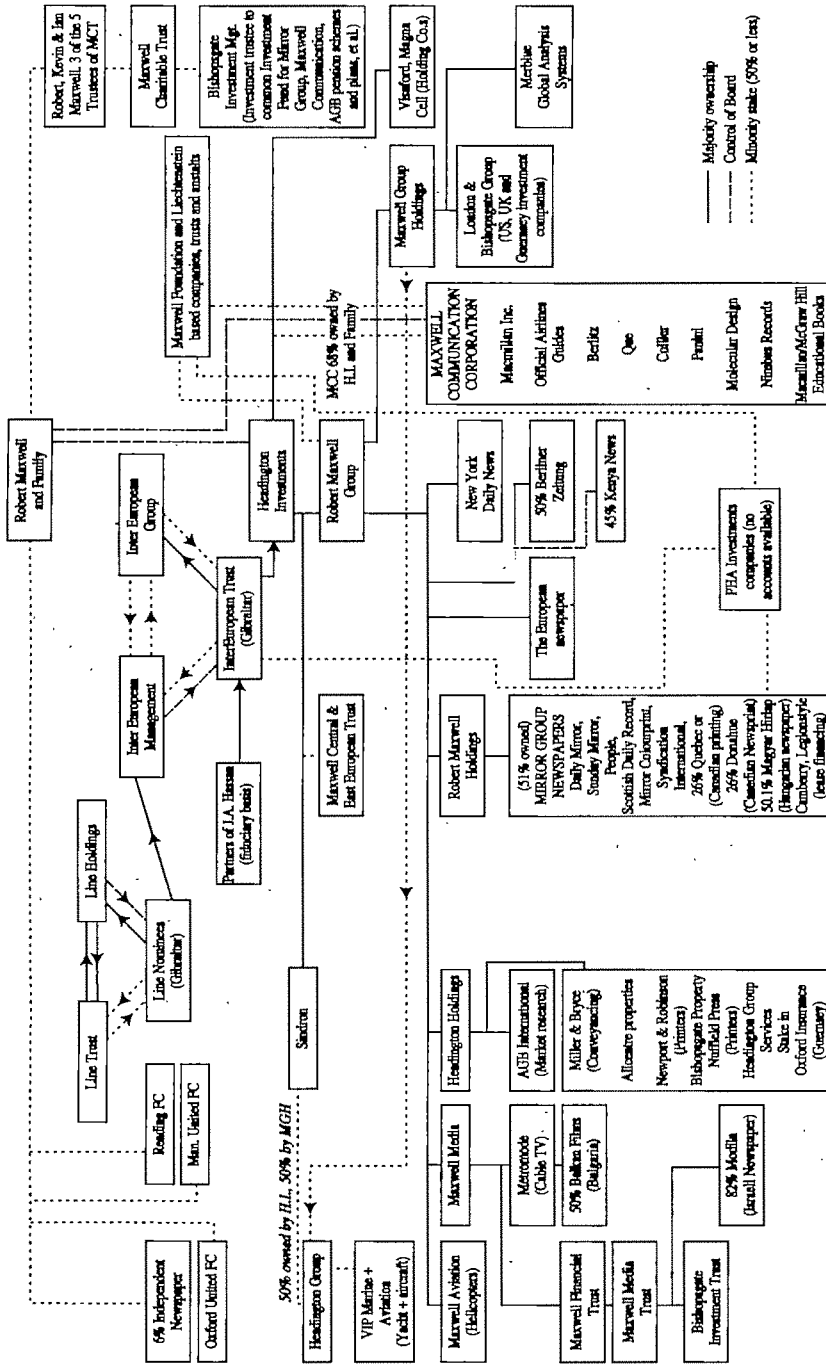
FIGURE 4.3

ROUND-ROBIN CHEQUES



Source: P. Murphy, *Interim Report of an Investigation . . . into the Affairs of Stanhill Development Finance Limited . . .* (1964, p. 41).

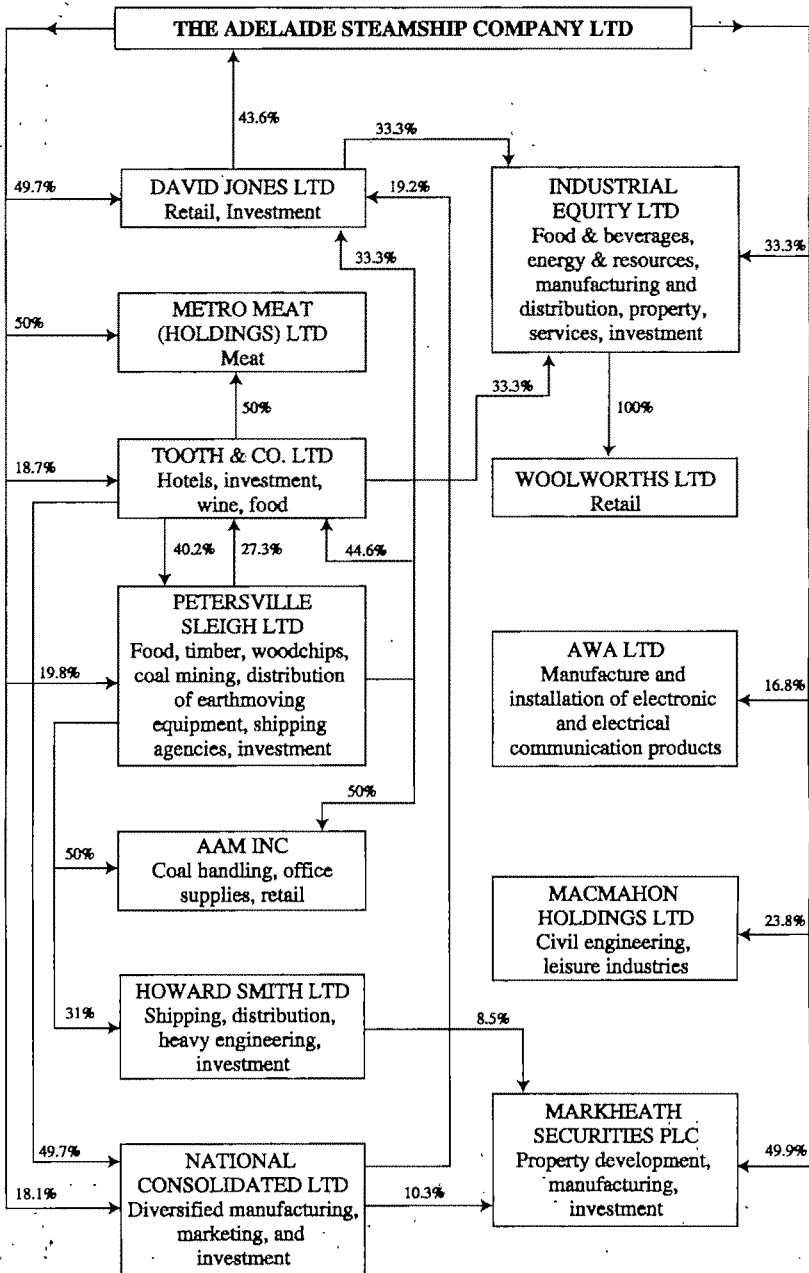
MAXWELL GROUP STRUCTURE



Source: Bronwen Maddox, *Financial Times*, 6 November 1991.

FIGURE 11.1

ADSTEAM GROUP STRUCTURE AS AT 30 SEPTEMBER 1990



Source: Australian Financial Review, 8 November 1990, p. 18.

GEORGE J. STAUBUS

Two Views of Accounting Measurement

The two views to be addressed here are the Chambers/Sydney view that accepts only one measurement method—current net realizable price—and the Staubus/mainstream view that accepts several measurement methods in the same financial report. These two views became well-established in the literature of accounting in the 1960s and their proponents have clung tenaciously to their oft-criticized positions for some forty years. However commendable their original expositions may have been, their continuing existence does no credit to the small coterie of accountants now interested in theory.

This article is aimed at ‘narrowing the areas of difference’ between adherents to the two views by isolating fundamental bases for them and exposing the reasoning supporting their structures. In a nutshell, they differ in their objectives and they can be expected to survive unless their adherents agree on the objectives of financial reporting.

Key words: Accounting; Chambers; Market price; Measurement; Staubus.

The literature of accounting theory includes two incompatible views of the measurement of enterprise assets and liabilities when current market quotations are unobservable. One, which I shall label ‘the Sydney view’, has been held by a small set of serious scholars scattered across the English-speaking world but especially associated with the name of the late Raymond John Chambers of The University of Sydney. That view has been adopted by several associates of Professor Chambers including Murray Wells, Frank Clarke, Peter Wolnizer, Graeme Dean, Michael Gaffikin and, most recently, Brian West. I shall forego naming adherents in other countries for fear of offending by omission.

The alternative view has been accepted by the accounting standards-setting establishment represented especially by the International Accounting Standards Board and the national standards-setting bodies of several major English-speaking countries. That view, incorporated in the decision-usefulness theory, has been associated with my name for several decades, so I might reasonably take some responsibility for a share of the disagreement. The standards setters have not, however, adopted my rationale for the use of a repertoire of measurement methods, and have developed their own term—attributes of an asset or liability—instead of measurement methods. I shall describe my own long-established view.

GEORGE J. STAUBUS is Professor Emeritus, University of California, Berkeley. staubus@haas.berkeley.edu I am grateful for the assistance of the anonymous referees and the editor for suggestions made regarding an earlier version of this article.

Why does this state of affairs continue to exist? To me, the small coterie of people seriously interested in accounting theory are subject to criticism for permitting it to exist for so long without exhibiting any evidence of intellectual discomfort. I am unaware of any attempts to reconcile the two views as bases for financial reporting,¹ or to show the value of having the two views—in the last third of a century. Personally, I am ashamed of the branch of accounting in which I have toiled for several decades, so feel compelled to address the anomaly. My long period of relative comfort was recently disturbed by my study (Staubus, 2004) of the admirable treatise by Brian West (2003) in which he adhered to the Sydney view.

My view and the Sydney view have much in common; I shall identify several such commonalities below. The heart of our difference is that the Sydney view provides for use of only *one measurement method*, which most recently has been labelled ‘current net realizable price’ (Chambers and Wolnizer, 1990, p. 71). Current cash equivalent was an earlier label. My (the majority) view provides for use of *several measurement methods*, or types of evidence of value. In both cases, the discussion excludes the measurement of cash, about which there is no disagreement.

In the ensuing paragraphs I search for the most basic level of our disagreement and the reasons for our disagreement at that level. In subsequent sections I attempt to trace routes that appear to lead to the different measurements, including hazards that might be encountered along the way. Speculations on the genesis of our disagreement follow. I regret to say that I cannot guarantee this search to be absolutely even-handed.

POINTS OF AGREEMENT

I see four important points of agreement:

1. Up-to-date observations of market prices are, in principle, more relevant to the concerns of financial statement users than are older prices. The current price of an asset or liability in the market in which it could be sold or liquidated is an excellent measurement of its value to the enterprise and its owners. (A good example is frequently traded securities.)
2. Reliability (freedom from bias, objectivity, accurate representation of the phenomena that the information purports to represent) is an important criterion of the value of bits of financial data. Note that the reliability criterion is applied to a specific application of a measurement method to a net asset (asset or liability) item, not to financial statements in general.
3. Additivity is an important characteristic of a set of measurements that are added or subtracted, meaning that all measurements included in a set of financial statements must be measurements of the same economic phenomenon and must be made in terms of the same unit of measurement. An implication is that a set of measurements made in monetary units of differing significance to users

¹ Allan Barton’s article dealing with the applicability of current costs and current cash equivalents in the theory of optimum resource allocation may be the most nearly relevant one to come to my attention (Barton, 2000).

of financial statements (as under inflationary conditions) is defective if adjustments are not made for those differences.

4. Conventional accounting has many serious defects.

SOURCE OF DIFFERENCES: OBJECTIVES OF FINANCIAL REPORTING²

Here I shall attempt to put my finger on the most basic steps in our reasoning at which there is a difference between myself and proponents of employing only one measurement method. I have previously made an effort to summarize my theory of accounting measurement in a one-page diagram, fully recognizing the risks entailed in such an abbreviation. That diagram appears as Exhibit 1. I have not found a comparable diagram in Sydney literature, so I shall attempt to construct one—Exhibit 2.

Information on Financial Position

My reading of the Sydney view discloses a clear-cut starting point—*financial position* and liquidity-oriented definitions of it.

Financial position is the capacity of an entity at a point of time to engage in indirect exchanges; it is represented by the relationship between the monetary properties of the means in possession and the monetary properties of the obligations of an entity. (Chambers, 1966, p. 101)

[Financial position] relates to the capacity of the firm as a whole to engage in or to vary any of the operations, assets and debts of the firm in any way deemed to be necessary or promising. (Chambers and Wolnizer, 1990, p. 71)

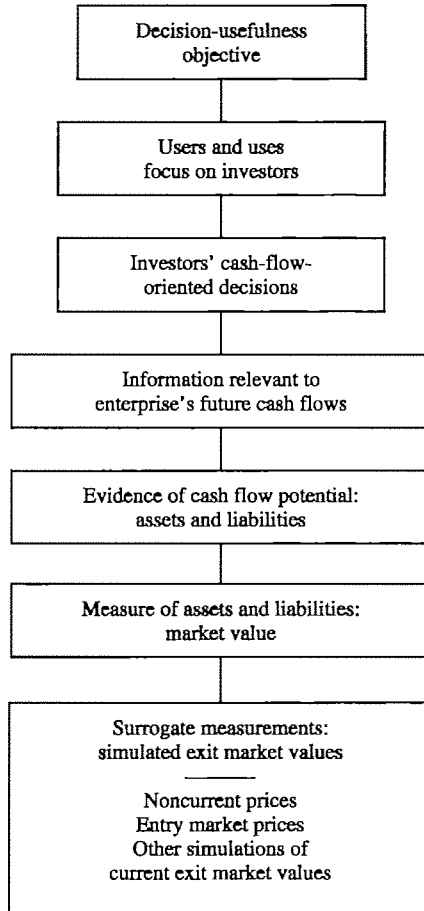
Contemporary financial position is ascertainable objectively by reference to the market, and is *relevant to all choices*. (Chambers, 1966, p. 101, emphasis added)

In relation to financial position the prices assigned to means in possession are realizable prices or current cash equivalents and the prices assigned to obligations are current cash equivalents. (Chambers, 1966, p. 101)

The focus here is on the very practical issue of current spending power. Consider the common situation of an *individual* who is facing a decision regarding the possibility of a major purchase that would require a large amount of money. A person's financial capacity to make the purchase is critical, so the individual's assets and liabilities need to be examined with a view to determining the amount that could be raised and prudently spent (providing for enough to pay off existing liabilities first). This is a situation calling for information regarding financial *adaptability*, which requires quick access to cash. The same information need applies to managers of the large business entities with which many professional accountants work. Furthermore, investors faced with the decision whether to liquidate the investee enterprise need that liquidity information.

² Chambers customarily emphasized functions (rather than objectives) of financial reporting (see Chambers, 1976a).

DIAGRAMMATIC OUTLINE: ACCOUNTING TO INVESTORS VIEW



The concepts of assets and liabilities of greatest interest to people are the ones described here. For example, a survey of independent professional persons' views of assets has shown that they must be saleable (Chambers *et al.*, 1984). Again, an authoritative dictionary's definition of *wealth*: 'All property that has a money value or an exchangeable value' (Webster, 1963, p. 2589). 'The significant concept and measure of wealth in a market economy is the monetary equivalent, or the sum of the market prices if sold, of all severable things owned' (Chambers, 1966, p. 70). Wealth is our subject matter; its measure is market price.

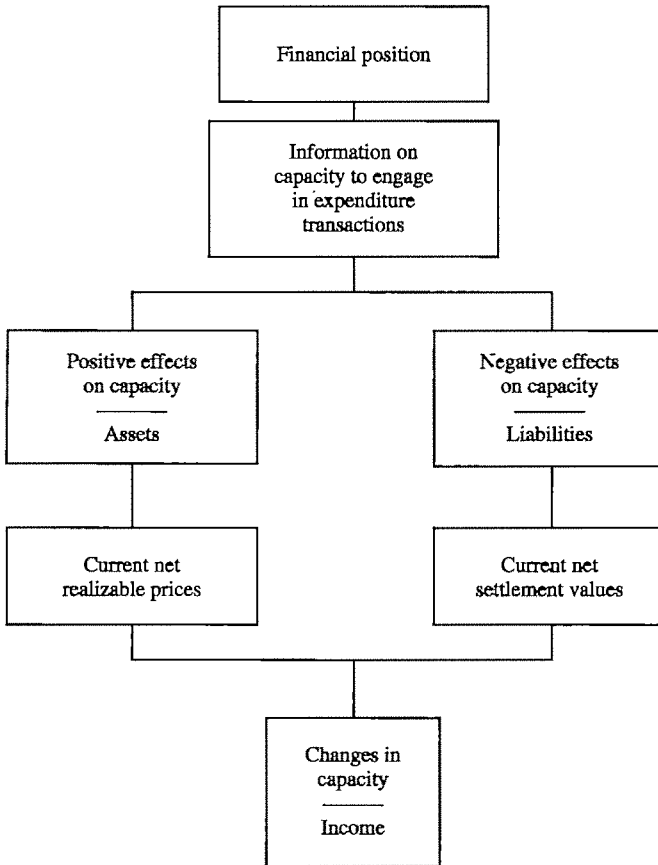
Decision-Useful Information for Investors

In my thinking, asking about the objective of financial reporting is the key that can lead us to many answers, especially to the decision-usefulness objective,

ACCOUNTING MEASUREMENT

EXHIBIT 2

DIAGRAMMATIC OUTLINE: THE SYDNEY THEORY



which, in turn, leads inexorably to questions regarding users and their uses. When I chose to focus on *managers* of an enterprise as users, identification of their uses of accounting information led me to an emphasis on activity costing (Staubus, 1971). When, on the other hand, I chose to focus on *external users*, an attempt to identify those users led me to investors (owners and creditors) and other parties seeking information on the success of investments in the enterprise, for example, taxing authorities, labor unions and others representing suppliers or customers of the enterprise (Staubus, 1961). My work on external financial reporting has always focused on the world of investors in securities who are concerned with the enterprise's future capacity to pay (cash, in the normal course of enterprise activities, unless otherwise stated). The result has been an emphasis on the positive and negative cash-flow potentials of enterprise assets and liabilities. In the absence of observable market quotations for those cash-flow potentials, a surrogate market

price must be chosen on the basis of its reliability and its relevance to investors' cash-flow-oriented decisions.

The typical investment decision maker of concern to me is a shareholder or prospective shareholder. If she is considering a purchase of a new home or a new automobile, she probably will want to check her personal liquidity situation. Similarly, if she is considering the purchase of shares in an enterprise, she needs to know her liquidity situation, often including her brokerage account balance, her bank accounts and her easily liquidated investments. If a share sale is under consideration, her liquidity may or may not be important. Whether it is a purchase or a sale, *holding* the shares is an option. To evaluate that option, she typically seeks information *from the enterprise* that will help her judge its capacity to pay dividends over some investment horizon. I call that *cash-flow-oriented information regarding the enterprise*.

In sum, Sydneysiders start with a focus on financial position (an enterprise's liquidity position), and the decisions of people controlling the enterprise's spending transactions. I start with the decision-usefulness objective and decisions by external investors who are vitally interested in prospects of cash flows from the enterprise, which leads to interest in the enterprise's prospective cash flows, almost always in the context of ongoing operations; rarely does an external investor have occasion to decide the question of enterprise liquidation. In my opinion, these are the most basic differences in the two views on accounting measurement. Neither is wrong; take your choice.

DIFFERENT ROUTES TO DIFFERENT OBJECTIVES

The Road to Financial Position Information

An accounting system yielding information on enterprise liquidity as described above presumably provides information on the current net realizable prices of all assets and liabilities at each reporting date. That clearly requires development of routine methods for ascertaining such prices for very many assets and liabilities in a large firm (Chambers and Wolnizer, 1990; 2000, p. 71). Certain cases might be easy ones, for example, marketable debt securities owned. Various categories of easily severed assets, especially mobile equipment such as common pieces of transportation equipment, are known to have markets that permit observation of prices without great difficulty. Real estate other than the most common types, including the fixed materials handling equipment (piping, conveyors) in the typical processing or manufacturing facility or 'public utilities', would appear to be more challenging, considering that every such asset is unique. It appears to me that no market price would be observable for a vast portion of what are conventionally viewed as the properties, plant and equipment of an industrial or commercial enterprise, given a reasonable standard of reliability. I doubt if cost would be a serious constraint.

In Chambers' major presentation of 'Continuously Contemporary Accounting' in 1966, he anticipated departures from a pure view of reporting at current exit prices. For example, in the cases of finished goods and work in progress inventories:

We may, therefore, take as the current cash equivalent the initial prices of the goods and services sacrificed in production, transformed to contemporary prices, and aggregated. If this sum exceeds the prevailing price of the finished goods, of course, the latter will be used, for in this case there is no doubt about the profit margin; there is no margin. . . .

[O]n the assumption that the firm has some future, the pricing of work in progress may be carried out on the same principle as has been suggested for finished goods inventories, by transforming acquisition prices of the goods or services sacrificed to prices at present ruling for those goods and services, provided their sum does not exceed the market resale price of the finished product. The pricing of raw materials inventories according to the same principle is relatively simple. . . .

Approximations to current cash equivalents are permissible where the market itself does not provide adequate information. (pp. 232, 233, 264–5)

Chambers went on to discuss ‘durables’ for which second-hand prices are observable and those for which no price can be observed. For the latter, ‘There seem, therefore, to be grounds for assigning no current cash equivalent to them’ (1966, p. 243). That means they must be written off upon acquisition.³ I interpret his 1966 position as providing for current cost as a surrogate for exit value for inventories, requiring the application of the ‘lower of current cost and market rule’, but not permitting current cost for property, plant and equipment; instead, if no second-hand prices are observable, the expenditure would be written off, as is the present general rule for expenditures on research and development. My readings indicate, however, that current cost is no longer an acceptable surrogate, in the Sydney view, for current net realizable prices (Chambers, 1995, p. 259), so write-offs must occur if no market prices for second-hand property, plant and equipment, work in progress, or finished goods inventories are observable. That is, the current view is indeed a single-measurement method view. Whether a loss should be recorded when saleable raw materials are put into process and a gain recorded when the processing yields a marketable finished good is not clear.

Is it fair to say that the treatment of physical assets with no observable market price is a large issue that would need clarification for the Sydney School’s single-measurement method system to be accepted as practically applicable? Either expenditures on such assets must be written off or estimates of current cash equivalent using methods (market value appraisals of plants?) subject to criticism on the reliability and cost criteria would need to be used. (This approach could be described as discovering an unobservable market price.) Otherwise, surrogates based on entry prices would seem to be the choice, thus departing from the single-measurement method view.

The immediate write-off of expenditures on non-marketable assets is an important feature of the Sydney single-measurement system. GAAP (generally accepted accounting principles) has the same feature with respect to many expenditures on intangibles that cannot be accounted for after acquisition at an acceptable standard of reliability. It is generally recognized as an unfortunate feature of

³ ‘Alternatively, or additionally, a memorandum account may be appended to the usual financial position statement, setting out the amount of the outlay and an equivalent part of the residual equity’ (1966, p. 245). This aspect was developed further in several pieces, for example, Chambers (1976c, p. 145).

GAAP because it discourages managements from investing in such assets in circumstances in which short-run performance reporting outweighs the long-run interest of investors. Observers of management performance have long recognized that whatever is measured and relied upon as evidence of performance will be emphasized by managers, so correspondence between measurements of management performance and achievement of investors' objectives is highly desirable. Immediate write-offs of expenditures that are made to yield intermediate to long-term benefits result in mismatching of costs and benefits, so must be counted as a defect in an accounting system. That must be especially apparent in cases of enterprises with such material amounts of non-marketable property, plant and equipment, and/or intangible investments that immediate write-offs would result in negative reported owners' equity. Unfortunately, the perfect measurement system is not available in a world of uncertainty; this imperfection is a price that must be paid to achieve the best possible measurement of financial position.

The Road to Cash-Flow-Relevant Information

The decision-usefulness approach to external financial reporting first identifies investors as the major users, then seeks to provide evidence of enterprise cash-flow potentials because that is of great interest to investors. If one sees a different core set of external users, a different measurement approach may be appropriate. However, I have observed that investors, including owners and creditors (suppliers, lenders, etc.) together with others, such as labour unions and tax collectors, who are interested in investors' success, constitute such an overwhelming portion of parties interested in enterprise financial reporting that they may be viewed as the general public interest, not a personal concern of one group. In the current investment environment, the investors that are most important to society are full-time professionals who manage the pension funds, the endowment funds, the mutual funds or investment trusts and so on, plus those providing the recommendations publicized by brokerage firms. When they 'get it wrong', we all suffer from the mispricing of securities. Their methods are important to society and to those engaged in producing the financial reports on which they rely.

In the world of finance, 'The value of any asset is a function of the cash flows expected from that asset' (Haugen, 1997, p. 48). Looking at shares in a corporation: 'We can say that shareholders' wealth is the discounted value of after-tax cash flows paid out by the firm . . . We shall assume that managers always make decisions which maximize the wealth of the firm's shareholders' (Copeland and Weston, 1983, p. 21).

This view of wealth items (assets and liabilities) is shared by finance practitioners and academics alike. Indeed, in finance, the type of schism that exists in accounting between academics and practitioners does not exist; each respects the other. Future cash flows are the heart of financial economics.

Of course, many investors, such as momentum investors and other chartists, make little use of financial statements. The type of investment analysis that does rely heavily on financial statements is called 'fundamental analysis'. According to

my reading of the relevant literature, the general working objective of 'fundamental analysis' is a forecast of the enterprise's future cash flows, because such flows must be the basis for dividends, interest payments and redemption of debt upon maturity. Reported earnings, adjusted for specific accounting actions that analysts do not trust, such as amortization of intangibles, possibly depreciation and inventory profits, and various non-recurring items, are accepted as approximations of normal cash flows under current operating circumstances. That version of cash flow is projected using information gathered by the analyst in the course of his/her intensive study of the enterprise and its industry. An alternative focus of the fundamental analyst is the price/earnings ratio, in which a stock's current P/E ratio is compared with its norm in an effort to find underpriced or overpriced securities. In such work, reported earnings are adjusted as described above to obtain a version of recurring earnings that is closer to recurring cash flows than the earnings reported in the crude financial statements. Analysis of the issuer's cash-flow prospects is even more important to investors in debt securities. Security analysis is an exceptionally subjective exercise, based on what the analyst hopes is a set of objective financial statements. The aim of accounting to investors is to provide those financial statements. The aim of normative accounting theory is to show how that objective can best be achieved.

The analysis described above is almost always based on the assumption of continuity of enterprise operations unless evidence to the contrary is available. It follows that analysts are interested in the established flow patterns of cash and other resources (operating cycles), not in immediate sale of assets not ready for sale or immediate payment of liabilities not due, unless evidence to the contrary is available. In any case, managers are expected to make the 'best uses' of assets and pay liabilities in the most advantageous patterns permitted by contracts; the 'as-is' exit values called for in the Sydney view are suitable only in the 'discontinued operations' case. '*Best-use*' exit values generally are more relevant to cash-flow-oriented decisions.

Accounting for units customarily referred to as assets and liabilities, as opposed to valuation of the enterprise as a whole, is the job of accountants. Users of financial reports do not want personnel of the enterprise to provide their estimates of enterprise value, and they understand that accounting for small components does not yield a sum that is a close approximation of enterprise value. The most valuable information that accountants can provide about individual assets and liabilities is their current market values. Investment company accounting is widely recognized as very good; in fact, buyers and sellers of investment company shares often accept the net asset value shown in the balance sheet as fair prices at which to buy or sell those shares—a great compliment to those financial statements.

Unfortunately, accountants have much greater challenges in reporting the net asset items of other enterprises at their current market values. They must resort to *surrogate measurements* in order to approximate the unobservable prices. It is important that those surrogates be chosen with regard to the realities of market economics. That is, those choices must be made using economic principles, not arbitrarily. Consider the case of contractual claims to cash or obligations to pay

cash at future dates, when there is no observable market price for the item. A principles-based measurement must allow for both the waiting period from measurement date to collection, using a discount rate observed in financial markets, and (in the case of the claim) a probability of failure of the debtor to pay (using an observed loss percentage). The reason for making those adjustments is that markets are observed to do so, and both users and preparers of financial statements must respect markets. The result is a 'simulated market price' that is tied to a genuine market price by principles-based adjustments (Staubus, 1985, 1986). It is not the output of the accountant's imagination.

Another example: Markets are observed to relate input prices to output prices. It is not necessary to assume perfect competition, in which the sum of an enterprise's input prices equal its output price, to understand that there is a relationship and that it varies widely in quality. Thus, current cost is a surrogate, of varying quality, for current exit price of an enterprise product; in some circumstances, it is a reasonable substitute for an unobservable exit market price. Similarly, yesterday's buying price is almost always a close surrogate for today's buying price, so historical acquisition price is a surrogate for current cost—the quality of the surrogacy depending heavily on the length of the time interval. Furthermore, it is clear that adjustment of an old price by a specific index, or even, at worst, by a general price index, typically provides a closer surrogate for current cost than the old, unadjusted 'historical cost'. Finally, the dividing line between usefully accurate surrogates and useless surrogates is a judgment call that principles-oriented accountants must make. On that basis, many intangibles, and possibly tangible assets, might be omitted from balance sheets. Most importantly, in principle, perfect measurements of assets are impossible, as every asset of every firm is *unique*, so the only perfect measurement of it is today's price for that unique asset; such a price can only be observed on the day it is purchased or sold (Staubus, 1996, pp. 47–54). *Accounting always uses surrogate measurements.*

This approach to the measurement of an enterprise's assets and liabilities is consistent with the work of professional financial analysts. They cannot have as much confidence in the resulting net book value of the owners' equity in the typical enterprise as they would in the case of the investment company, but if they find any accounting-based financial reports useful, reports based on the above measurement scheme are the ones.

Two aspects of this approach to obtaining objective market measurements of enterprise assets appear often to be misunderstood. One is that the surrogate relationships on which the value of clearly imperfect measurements depend are firmly embedded in real world economics. The other is that all of the readings of market prices are market assessments of wealth items, so meet the additivity test. The necessity to add measurements and estimates of quantities obtained by different techniques is well accepted in those sciences heavily dependent on measurements that are never perfect, such as physics, just as it is in all branches of economics. Income is the change in enterprise net assets other than in transactions with owners. Analysts must make their own judgments whether an item should be considered recurring or non-recurring.

One other observation on the array of measurement methods I have described: Current cost appears to deserve a prominent role in the accounting for long-term and short-term assets held for use, such as many unique items of property, plant and equipment, and inventories of raw materials and work in process. I find that current cost also typically is relevant to *managerial* decisions regarding the consumption of such assets, so the incremental cost of using it in external reporting could be low (Staubus, 1971, pp. 6–9).

I have suggested (1985) that this view of market simulation is implied in GAAP but is implemented very crudely because accountants have not articulated a theory of GAAP. It is clear that standards setters are moving, slowly and with strong opposition from corporate managements, towards improved implementation of this intuitive, natural understanding of investors' interest in enterprise wealth. In particular, one specific interest in improved accounting that is shared among Sydneysiders, standards setters and myself is the value of updating old market price measurements.

One criticism of this type of accounting is that it does not provide satisfactory information on enterprise liquidity. That criticism cannot be fully countered by inclusion of a historical cash-flow statement and the listing of the more liquid assets and liabilities first on the balance sheet. Those users who place more value on liquidity information than on information relevant to future cash flows in the normal course of business are poorly served by the latter. A circumstance in which liquidity information is likely to be preferred is the case of an enterprise whose future as a going concern is in sufficient doubt that the auditor's certificate includes a 'going concern exception'. Chambers always held that accountants should not make that judgment and that under CCE accounting it is not necessary.

SPECULATIONS ON THE GENESIS OF THE DISAGREEMENT

I have consistently based my work in accounting theory on the decision-usefulness objective since 1953, when I filed my completed dissertation with the University of Chicago faculty (Staubus, 1954/1980), and have worked towards development of a theory based firmly on that objective since that time. Many people concerned with improving financial reporting have accepted that objective in the last fifty years, including the standards-setting establishment. As noted above, a key step in that theory is the identification of users of financial information and the uses of it. In 1958, I completed a version of my theory labelled *A Theory of Accounting to Investors*, a title that I considered awkward but accurate. On 29 December 1958, I wrote a fan letter to Ray Chambers shortly after having read the first of his papers to come to my attention. The lengthy letter included: 'I personally rank it as the best accounting paper that I have ever read'. Actually, I subsequently found several of Ray's that I think were better. I followed Ray's work fairly closely for many years. In that time I have not found a serious analysis of users and uses of external financial reports, or of internal reports either, for that matter. In my opinion, that is the reason for our difference. It should not be surprising that two travellers heading for different destinations take different routes.

Another difference between us, I believe, has been our interests in enterprise management and investments. Ray spent a number of years in business enterprises as a youth, I believe. I never did. He turns to that setting often, it seems to me. On the other hand, I have been an investor in corporate stocks and bonds for fifty-five years. I have no information regarding Ray's investments. Also, I have been involved with the work of a fine faculty in finance, including participation in its conferences and workshops, so have learned something about financial economics and the use of financial statement information by professional investors. At one time I found economics more interesting than accounting, and I have continued my interest in microeconomics. I do not know if my experience in finance is any more extensive than Ray's, but it might be. I have not seen evidence of such interest in his written work. I speculate that this difference in interests has been a factor in our views on the uses of financial statement information and on accounting measurement. That difference may account for Ray's acceptance of a liquidity-oriented version of wealth, as opposed to the utility-oriented view that has been gaining ascendancy among economists. I confess that I am far less familiar with the works of other Sydneysiders.

Another field in which our interests have differed, according to my observations, is psychology. In his 1960s works, Ray discussed matters such as the relief of strains and adaptive behaviour at a level that I could never match. I suspect that his interest in switching asset holdings ties to that interest in adaptive behaviour.

These speculations may be entirely wrong, of course. I do believe, however, that the basis of our different views on useful enterprise financial information can be found somewhere in our different backgrounds.

Another point of difference might be noted. The literature of the Sydney point of view occasionally suggests that the adaptability view of financial position is relevant to all actions requiring information on financial position, and that it is useful to any and all actors who need to know the enterprise's financial position. That literature has suggested that accounting information should be of general usefulness—that specific, personal uses should not be the concern of the accountant. That seems to contrast with my concern for identifying users and uses of financial information. One could be concerned that my approach could lead to different information for every user, or every group, which would present the accountant with a hopeless task.⁴ I plead guilty to concern for specific categories of users and have worried about conflicts between their needs. However, my early reviews of user groups and their needs identified investors and others interested in investors' successes and prospects as having common interests in the enterprise's future capacity to pay, and I found only two other important user groups: tax and regulatory authorities, and managements. I agree that the specialized needs of the former can impose burdens on accountants, and I do not know how to meet their needs and investors' needs in one set of financial statements, although those

⁴ Chambers addressed this issue (1976) in his response to Demski's position on the impossibility of normative accounting standards (1973).

authorities' interest in investors' success results in much overlap. In the case of managements, I have investigated their needs and find that they do, indeed, need information that investors do not; a major difference is in the level of detail required. However, if managers are viewed as working in the interests of owners, then success for managers should be measured by their meeting owners' objectives, thus giving them interests in the same views of wealth and income as the owners hold, so no different accounting measurements are required. If managers do not seek to achieve owners' objectives, I must confess to neglecting their 'needs'. So I do not see that focusing external financial reporting on the needs of investors can be criticized as excessively personal, or that it causes any easily remedied problems—at least none comparable to those caused by not enquiring about users' needs. If one sees external financial reports as properly focusing on investors' needs as too restrictive, some explanation of any conflicting needs would interest me, and perhaps many others.

At another level, our different views seem to make use of different readings of two concepts that impact our choices of measurement methods: additivity and surrogacy. Ray firmly believed that current cost measurements and exit value measurements were not additive. I believe that a market price at which an asset was purchased and a market price at which an asset could be sold are comparable to apples from different orchards rather than to an apple and an orange. No two apples are identical, just as every asset is unique, in the context of the economics of financial markets. Requiring perfect identity of apple A and apple B would prohibit reporting the existence of two apples. Nor are any two markets equal. Market values that vary in many respects but are measured in Australian dollars are added in useful economic aggregations. With regard to surrogates, my view of the economic relationship between buying and selling prices, and between a price today and a price yesterday, is that in the absence of information regarding one, the other can be a useful, imperfect substitute.

But more fundamentally, I believe we disagree on what we are trying to measure. Ray concentrated on adaptability, which 'embraces every action related to survival—capacity to pay short-run debts, cover for long-term debts, capacity to pay wages, trade accounts, dividends and taxes and so on' (1976c, p. 145). He insisted that he was not concerned with liquidation, and I accept that. But he surely was concerned with capacity to raise cash in the short run. That interest was in conflict with his equally strong insistence that 'The whole of the accounting was intended to be accounting for going concerns' with measurements of CCE of assets 'in the ordinary course of business' (1974, p. 130). That may be the basis for the continuing arguments over the measurement of non-vendibles, bonds payable and accounts receivable. In contrast, I focus on the management's responsibility to make the best use of the firm's assets in the interest of investors. In the majority of cases, non-redeployability of so many assets makes continuity the best course. Surrogate measurements are the only reasonable solution in such circumstances. That approach, of course, is subject to another set of questions regarding observability of the evidence, relying on predictions, etc. Again, evaluate the alternatives and take your choice.

CONCLUSION

The Sydney view and the decision-usefulness view differ in their starting points, the decision makers addressed, the decisions to be informed, and the populations whose concepts of wealth are accepted. Those differences bring us to different prescriptions for the measurement of assets and liabilities when current exit market prices are unobservable. The Sydney view begins with a concept of financial position, addresses the concerns of those with spending authority and their spending decisions, and emphasizes entity managers' practical concept of available wealth. The decision-usefulness view begins with an enquiry regarding the objectives of financial reporting which leads to the usefulness of financial reports in making decisions, especially those of investors, thus focusing on the view of wealth held by participants in financial markets. On the other hand, the two views agree on the need for information useful in making decisions, the value of up-to-date measurements, the additivity requirement, and the importance of the reliability criterion. It has been a pleasure to travel with Ray Chambers on the road to better financial reporting.

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MASAYOSHI NOGUCHI AND JOHN RICHARD EDWARDS

Accounting Principles, Internal Conflict and the State: The Case of the ICAEW, 1948–1966

The series of Recommendations on Accounting Principles (RoAPs) issued by the Institute of Chartered Accountants in England and Wales (ICAEW) between 1942 and 1969 demonstrated the willingness of a professional accounting body to take a degree of responsibility for the form and content of British corporate financial reports. RoAPs 12 and 15 focused on the enduring problem of whether and how to take account of changing prices when constructing published financial reports. This article reveals disagreement between practising and industrial members in general, concerning how to address this issue, and examines the way in which the Council of the ICAEW sought to resolve this internal conflict within the constraints imposed by the need to be seen to behave in the 'public interest'. Major discord between the two main categories of membership emerged within the operation of the Taxation and Financial Relations (T&FR) Committee. What were judged by the ICAEW's leadership to be the extreme views of the industrial members were marginalized and suppressed by bypassing the normal channel for designing RoAPs and, instead, formulating them at the higher level of the Parliamentary and Law (P&L) Committee. The conflict between practising and industrial members continued in the period following the publication of RoAP 15, when further attempts were made to tackle the problem of accounting for inflation.

Key words: Industrial accountants; Inflation; Institute of Chartered Accountants in England and Wales; Practising accountants; Recommendations on Accounting Principles.

The use of historical cost as the measurement basis when preparing the profit and loss account and balance sheet came under serious challenge, in the accounting

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literature, in the 1920s and 1930s. It was the rapidly rising price levels in France and Germany (hyper-inflation caused the collapse of the German mark in 1923) that generated a literature critical of historical cost accounting and advocating, instead, the adjustment of accounts for changes in the general price level (Clarke, 1980, p. 91). German writers, such as Schmidt (1930, pp. 239-40; 1931, pp. 291-2), made the case for the restatement of assets at replacement cost, and this approach found favour also in the Netherlands and the United States.¹ In Britain, prices had risen rapidly during World War I but had dropped back to pre-war levels in the 1920s. A similar trend failed to occur following World War II; indeed, the price level continued to rise fairly rapidly in the late 1940s and accountants in Britain at last turned their attention to the problem of accounting for inflation. It has been a major issue ever since, and remains unresolved despite continuous debate; the publication of two Recommendations on Accounting Principles (RoAPs), and the construction of Statements of Standard Accounting Practice (SSAPs)² that gave recognition to two contrasting models of financial reporting; and the construction of the *Statement of Principles for Financial Reporting* (ASB, 1999) which is designed to provide the conceptual basis for the Financial Reporting Standards presently in issue.

Two decades ago, Tweedie and Whittington (1984, p. 1) pointed out that

the inflation accounting debate is merely one example of the problems facing accounting. There is a lack of generally accepted accounting principles because a changing environment has made traditional principles obsolete, and the process of evolving new principles is essentially political, involving the reconciliation of the conflicting interests of various groups of preparers and users of accounts.

The depth and complexity of the 'conflicting interests' is demonstrated in this article, which reveals the failure to reconcile, in the 1950s and 1960s, the divergent priorities of the membership of a single professional accounting body, the Institute of Chartered Accountants in England and Wales (ICAEW). The views of that organization were of particular significance for reasons which include the following: it was comfortably the largest accounting association³; it had established its credibility with the state by issuing a series of RoAPs that were influential in constructing the accounting regulations introduced by the Companies Act 1948

¹ Much of the relevant pre-World War II literature is reviewed or referred to by Tweedie and Whittington (1984, ch. 2). For the development in the Netherlands, particularly the work by Theodore Limperg, see Mey (1966), for Germany, particularly the work of Fritz Schmidt, see Clarke and Dean (1986) and for the United States, particularly Henry Sweeney, see Sweeney (1936) and Zeff (1976).

² Provisional SSAP 7, *Accounting for Changes in the Purchasing Power of Money*, was issued in 1974 and SSAP 16, *Current Cost Accounting*, in 1980.

³ In 1951, the ICAEW had 16,079 members compared with the 9,000 members of the Society of Incorporated Accountants and Auditors, which it took over in 1957, and 18,980, in aggregate, for the other five major U.K. accounting bodies. The corresponding figures in 1961 were 35,600 for the ICAEW and 30,169 for the other five major bodies (Matthews *et al.*, 1998, p. 62).

(Zeff, 1972, p. 16; Bircher, 1991, pp. 231–2); and, compared with most other accounting associations at that time, it possessed chartered status (Willmott, 1985, p. 47).

PURPOSE

The Council of the ICAEW issued two RoAPs on inflation and accounts: RoAP 12, *Rising Price Levels in Relation to Accounts*, in January 1949; and RoAP 15, *Accounting in Relation to Changes in the Purchasing Power of Money*, in May 1952. In Edwards' (1989, p. 251) estimation: 'No. 12 gave unreserved support for the continued use of HCA [historical cost accounting] but, after criticism, No. 15 signalled a minor tactical retreat by advocating the continued use of HCA "unless and until a practical and generally acceptable alternative is available"'. To the outside world, the stance of the ICAEW in adhering to the historical cost basis was robust and unequivocal. This image was acknowledged by *The Accountant*.

In Great Britain the Institute's recommendations, which carry the authority of the Council, are issued without details of any dissentient views of any of the members of the Council; it seems reasonable, therefore, to assume that before publication the Council will have reached a degree of consensus amounting for practical purposes to unanimity and that without substantial unanimity no recommendation would emerge. (15 January 1949, p. 33)

Edwards (1989, p. 251), Tweedie and Whittington (1984, pp. 45–6), Mumford (1979, pp. 100–1; 1983, p. 71), Zeff (1972, p. 17) and Gynther (1966, pp. 21–32) acknowledge the existence of *inter-organizational* disagreement between the ICAEW and other accountancy bodies which favoured the adoption of replacement cost accounting, but they pay little or no attention to the possibility of *intra-organizational* conflict within the ICAEW. Gynther and Mumford recognize the tension produced by the different priorities of practising and industrial accountants, within the arena of inflation accounting, but do not address this issue in the context of the formulation of RoAPs. Zeff (1972, pp. 12–13) acknowledges the possibility of conflict arising within the operation of the Taxation and Financial Relations (T&FR) Committee and that, in such circumstances, Council might decide to override the wishes of the T&FR Committee:

The votes of the Council on Recommendations were never revealed.⁴ Dissents and dissenting opinions were not recorded . . . Nothing about any modifications made by the Council was disclosed . . . It was not known, of course, the extent to which any Recommendation embodied the views of the T. & F. R. Committee. It was entirely possible for a Recommendation not even to originate in the committee: It might have been written by the Council itself.

However, the absence of total unanimity within the ICAEW on the specific issue of inflation accounting is referred to by Zeff (1972, pp. 24–5) only when commenting on factors contributing to the creation of the Research Committee in 1964:

⁴ Zeff presumably means that information on the developmental process of particular RoAPs was never disclosed to the public. This information was, of course, available in the internal documents of the ICAEW.

Another factor may have been the frustration experienced by several members of the Council in trying to persuade their brethren on the merits of replacement-cost or price-level accounting. At least one serious attempt had been made since 1954 to change the Council's thinking on Recommendation 15, but it lost . . . The first publication to be identified with the [Research] committee appeared in 1968. A 24-page booklet entitled *Accounting for Stewardship in a Period of Inflation* . . . The possibility of issuing such a document had been referred to the [Research] committee following the failure of the most recent drive, which had consumed almost four years, to dissuade the Council from its position in Recommendation 15.

In the above literature, not only the existence of friction between industrial and practising members within the ICAEW, but also the significance of their conflicting priorities, is left unexplored. It is therefore the purpose of this article to undertake an in-depth analysis of the internal tensions that arose between different categories of membership within a professional body and the governance issues that resulted. The arena for this examination is the developmental process of RoAPs 12 and 15 which, as we shall see, gave rise to disagreement between practising and industrial members in general, concerning how to resolve the theoretical and practical accounting issues that needed to be addressed. We examine the way in which the Council of the ICAEW sought to settle this internal conflict within the constraints imposed by the need to be seen to behave in the 'public interest'. The article also builds on Zeff's earlier work to show that it was continuing internal conflict between practising and industrial members that subsequently prevented the ICAEW from formulating further RoAPs on inflation in the period up to 1965.

The remainder of this article is structured as follows. First, we draw attention to the existence of different priorities, within the membership of the ICAEW, concerning the nature and purpose of profit measurement procedures. Next, we review the way in which the T&FR Committee operated when preparing technical documents, and focus on the friction between the T&FR Committee and the machinery of Council that was responsible for controlling technical activities within the ICAEW, the Parliamentary and Law (P&L) Committee. The remaining sections explore the nature and significance of the processes followed when developing the RoAPs on inflation and accounts, and then investigate further related unsuccessful initiatives in the period up to 1965 before presenting our concluding remarks. The main primary sources consulted for the purpose of this study are located at the office of the ICAEW in Milton Keynes, England.

CAPITAL MAINTENANCE CONCEPTS; PROPRIETORSHIP VERSUS ENTITY

The ICAEW was created by Royal Charter in 1880 and, as Willmott *et al.* (1993, p. 71) have pointed out, this imprimatur of the state 'confers a privileged status on a trade association in the sense that it differentiates those who qualify as members from other providers of (accounting) labour'. Although such recognition may be an important event in the pursuit of a professional project (see Larson, 1977, p. xvii; Macdonald, 1985, p. 542; 1995, p. 188), it is a two-edged sword; recognition is granted 'in exchange for an undertaking that this function will be performed "in

the public interest”’ (Willmott *et al.*, 1993, p. 71). The ability of an association to deliver its own side of the bargain is likely to become more problematic if, and when, the membership becomes dispersed and segmentalized. The association is then faced with the task of reconciling and balancing not only the public interest with the self-interest of its members, but also coping with the fact that the self-interest of different segments might conflict.

The formation of the T&FR Committee in August 1942 (renamed as the Taxation and Research [T&R] Committee in 1949 and the Technical Advisory Committee in 1964) and the publication of technical documents by the ICAEW have been recognized as key landmarks in British accounting history (*The Accountant*, 30 October 1943, p. 205) by reflecting the willingness of a professional accounting body to take formal responsibility for the development of improved accounting practices. Indeed, the formulation of the series of RoAPs⁵ has been hailed as the T&FR Committee’s greatest achievement.

The T&FR Committee was initially created also to help cope with the problems created by the increasing segmentation of the ICAEW-led accounting occupational group. The ICAEW had been formed to represent the interests of public accountants, but by 1939 the number of qualified members who had ‘left the profession’ to take up full-time posts in industry or commerce had risen to 1,612 compared with 5,210 in practice at that time (ICAEW membership list, 1939). Many of these industrial members believed that the ICAEW failed to represent their interests and was not even concerned to hear their views, as epitomized by the absence of even a single representative on Council (see Zeff, 1972, p. 7; Smallpeice, 1944, p. 45). The T&FR Committee, comprising members drawn from practice and industry, was created as a body designed to help achieve a closer and more effective liaison between the two groups and to provide industrial members with a voice in decision-making processes of the ICAEW.

Despite a common professional education, it does not necessarily follow that industrial members’ views on technical matters will be in accord with those held by practitioners. This is principally because, as the ICAEW admits, the problems that industrial members have to face are ‘of a different character in their practical application to those confronting the practising members’ (Ms.28432/19). A study by Hastings and Hinings (1970, p. 358) confirms that industrial and practising accountants attach different weights to shared professional values: ‘Chartered Accountants employed in industry would [be expected to] exhibit less attachment than do Chartered Accountants in public practice to four professional values (caution, exactitude, anti-theoretical pragmatism, professional exclusiveness) but no lessened attachment to the other two professional values (quantification and rationality)’. It is of course the case that one reason for including people with different backgrounds, on any committee, is to improve the available knowledge base. But, variations between professional groups in the level of attachment to particular professional values can produce a conflict that is hard to reconcile.

⁵ These comprise twenty-nine statements mainly drafted by sub-committees of the T&FR Committee and issued by the Council of the ICAEW over the period from 1942 to 1969.

A vital issue in the inflation accounting debate, and the central focus of this article, is the nature of capital to be maintained intact when measuring reported profit. Tweedie and Whittington (1984, pp. 281-2; see also Tweedie, 1979, p. 18; Whittington, 1981a, pp. 5-6) delineate three possibilities in a manner suitable for our purposes:

- (1) financial capital—the equity stake in an enterprise in money terms;
- (2) real financial capital—the equity stake in an enterprise in real terms (the proprietary concept); and
- (3) operating capacity capital—the ability of the enterprise to maintain its ability to provide goods and services (the entity concept).

Financial capital is, of course, the historical cost-based capital maintenance model which was, and still is, the subject of attack from proponents of price-level adjusted models. We will see evidence of the fact that the interests of practitioners as auditors, and the dominance of practitioners within the ICAEW, caused its leaders to persistently emphasize the criterion of objectivity (Whittington, 1981b, p. 70; Westwick, 1980, p. 356). Their assessment of alternatives to historical cost accounting was, therefore, *always* cautious and pragmatic.

Where price-level adjusted models for financial reporting were the subject of serious discussion, a common area of dispute concerned the purpose of the profit measurement process; whether it was to maintain intact the 'real financial capital' (the proprietorship focus) or the 'operating capacity capital' (the entity focus) of the enterprise. In deciding between these alternatives, the assessment made by Gynther (1966, p. x), writing during the time-frame of this article, is insightful. He argues that 'the attitude adopted depends on whether one tends to look on a firm from without or from within'. Gynther continues (pp. 44-5):

If it is felt that the whole purpose of accounting is to look after the interests of the shareholders or proprietors, then it is almost certain that the use of one general index will be favoured for profit determination purposes; so that the number of purchasing power units contained in the monies subscribed to the business by shareholders will be maintained throughout a period of changing prices. However, if it is believed that the whole or prime purpose of accounting is to assist the entity (the firm) in its daily struggle (and that only in this way will the interests of shareholders be looked after in the long run), then it is almost certain that the use of specific indexes will be favoured, i.e., so that the physical assets of the business will be maintained during the period of changing prices.

Practising accountants, in Gynther's (1966, pp. 44-5) estimation, favour the use of a general index because their duties relate to the protection of the interests of shareholders, whereas industrial accountants prefer to use a specific index (replacement cost accounting) because their priority is to maintain intact the operating capacity of the company for which they work (see also Gynther, 1967, pp. 282-5). Mumford (1991, p. 130) makes the same point and also the following observation: 'when faced with price inflation, auditors have typically preferred using historical costs to current values, as being more objective and less open to manipulation'. He also supplies a specific example based on an interview with E. H. Davison. When Davison, a member of the ICAEW who had worked in industry for some

years, became chief accountant of Courtaulds, he pressed for the adoption of replacement cost accounting, but the finance director 'had been appointed straight from Price Waterhouse, and opposed innovation along these lines' (quoted in Mumford, 1991, p. 130). Those differences between the mindsets of accountants in business and in practice will be shown to have significantly undermined ICAEW initiatives designed to resolve the inflation accounting issue.

RULES GOVERNING THE OPERATION OF THE T&FR/T&R COMMITTEE

As noted above, the T&FR Committee was created, in 1942, to help establish an effective liaison between practising and industrial members through collaboration in the study of technical matters (Ms.28432/19; Ms.28423, p. 2). In particular, the terms of reference of the General Advisory Sub-Committee (GASC), the body initially responsible for drafting RoAPs within the T&FR Committee, included the requirement 'to consider, *inter alia*, general questions of accounting principles and procedure and any other matters of mutual interest' to practising and industrial members (Ms.28423, p. 11).

The mechanism for producing technical documents, particularly RoAPs, is explained by Zeff (1972, pp. 11–12), and its main features are summarized in Figure 1.⁶ Zeff (1972, p. 10) also explains why Council retained close control over the content of technical documents, including RoAPs, drafted by the T&FR Committee: 'An axiom of the English Institute . . . is that only the Council may authorize the issuance of guidance statements to members. While factual surveys, in the form of books, booklets, or short papers, may carry the name of an Institute committee, the Council must authorize their publication.'

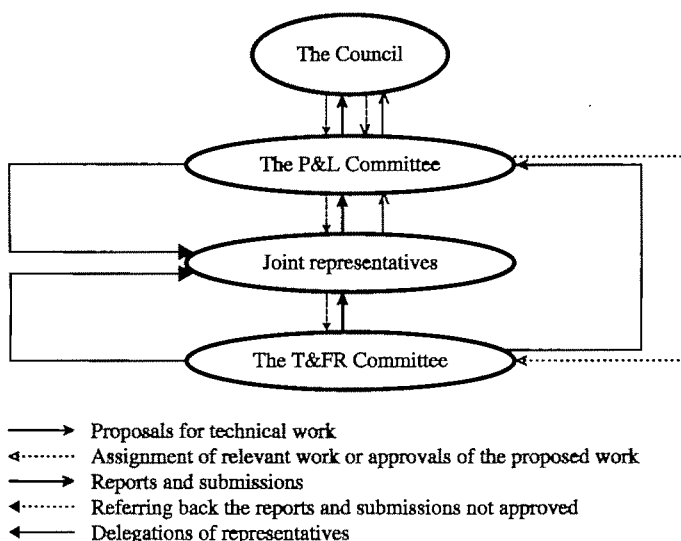
The ICAEW's leadership was keen to retain close control over technical outputs, partly in order to ensure that their content maintained an appearance of neutrality towards sectional interests such as the owners of business. Such neutrality, the leaders of the ICAEW noted, would foster the image of an institution behaving independently and in the 'public interest', and thereby help achieve legitimization of itself with relevant government departments. The following examples are manifestations of this conviction.

The minutes of the Taxation Sub-Committee (TSC) meeting of the T&FR Committee, held on 17 September 1943, state: 'Mr. Carrington [chairman of the

⁶ Consistent with the content of Figure 1, an internal report dated 19 June 1957 explains the relationships as follows: '[a]ll the activities of the Taxation and Research Committee are subject to the overriding authority of the Council. These activities are dealt with through the Parliamentary and Law Committee. The normal procedure is for matters to be brought to the Parliamentary and Law Committee through a committee of joint representatives consisting of representatives of the Parliamentary and Law Committee and representatives of the Taxation and Research Committee. The representatives of the Taxation and Research Committee are selected on the occasion of each subject . . . When a document comes before the Parliamentary and Law Committee the chairman and one member of the relevant sub-committee of the Taxation and Research Committee may attend the meeting of the Parliamentary and Law Committee' (P&L Committee Minutes Book G, pp. 96–7).

FIGURE 1

GENERAL STRUCTURE OF THE PRODUCTION OF TECHNICAL DOCUMENTS
THROUGH THE ACTIVITIES OF THE T&FR COMMITTEE



TSC] . . . has explained that the suggested representations [to the Inland Revenue]⁷ might destroy the impartial position now held by the Institute and its members' (Ms.28424, p. 20).

A report of the TSC on taxation on overseas profits, dated 18 November 1952, concluded:

The Taxation Sub-Committee is unable to find any logical principle running through any of the methods . . . It may well be that arguments both for and against such methods can be formulated on the basis of political considerations or sectional interests. The Taxation Sub-Committee considers that this is not a field into which the Council of the Institute should be drawn. (Ms.28424, p. 191)⁸

The minutes of the P&L Committee (25 February 1952) report correspondence from J. Clayton, a member of the ICAEW and director at Broadcast Relay Service Ltd, to W. H. Lawson, chairman of the P&L Committee⁹ and a partner in Binder, Hamlyn & Co., criticizing evidence drafted for submission to the Royal Commission on the Taxation of Profits and Income:

⁷ The planned representation intended to advocate, in cooperation with the Law Society, some income tax allowances for professional persons, including accountants and lawyers (Ms.28424, p. 19).

⁸ The minutes of a meeting of the TSC held on 10 January 1961 confirm that 'the Institute generally endeavoured to avoid taking the part of sectional interests' (TSC Minutes Book C, p. 1).

⁹ For successive chairmen of the P&L Committee, see Appendix A.

In the current document . . . the Council stands in grave danger of losing its objectivity by advocating special relief for owners of businesses. It may well be that the F.B.I. or some other body representing the sectional interests involved may properly put up powerful arguments for such relief, but there is no indication at all in the document that all the evidence has been weighed by the Council which would justify this grave departure from objectivity . . . the Council appears to be shifting its objective position merely as a result of the heavy pressure groups which, at least externally, have been exercising undue pressure upon it . . . It would be understandable in these circumstances if the Council of the Institute were to advocate special tax concessions to . . . the holders of fixed interest securities, the value of whose holdings have been at least halved by inflation in the last decade. But for the Council to advocate special tax concessions to those who in general have benefited from inflation at the expense, presumably, of those who have suffered from it, is, to use the mildest of expressions, 'truly Gilbertian' [reasoning]. (File 14-5-20)¹⁰

The original draft memorandum was then amended by the P&L Committee to make it more objective and to 'avoid any possibility of Council being open to the criticism that it had taken sides as between one class of taxpayer and another' (File 14-5-20).

The ICAEW was equally determined to avoid any accusation of connection with purely interest-representing organizations. The minutes of a meeting of the P&L Committee held on 21 November 1966, for example, insist that it is 'inappropriate for the Council to seek to establish a closer official relationship with the C.B.I. [Confederation of British Industries], as such a course might compromise the Council's independence' (P&L Committee Minutes Book Q, p. 31).

The above episodes help to explain the P&L Committee's determination to maintain strict control over the T&FR Committee when fulfilling its responsibility for drafting technical documents, but intervention sometimes produced serious friction between the two bodies. In the course of preparing RoAP 7, entitled *Disclosure of the Financial Position and Results of Subsidiary Companies in the Accounts of Holding Companies*, in May 1944, the T&FR Committee submitted a draft to the P&L Committee that was approved only after extensive amendment. The chairman of the T&FR Committee, F. R. M. de Paula, vice-chairman and managing director of Harding, Tilton & Hartley,¹¹ instructed S. W. Rowland, secretary of the T&FR Committee, to write to R. W. Banks, secretary of the ICAEW:

¹⁰ Clayton further argued that '[i]nflation benefits debtors and the owners of tangible assets, and is detrimental to the interests of creditors and owners of cash and fixed interest securities. According to figures published from time to time in *The Economist*, the owners of businesses—that is, equity shareholders—are included among those who, as owners of tangible assets and net debtors, benefited from inflation' (File 14-5-20). Another letter from Clayton to C. W. Boyce, ICAEW president 1951–52, dated 25 February 1952, stated that 'to tail behind the Federation of British Industries and the Association of British Chambers of Commerce (the proper advocates of the particular interests of the business community) would represent a surrender of that independence and objectivity wherein lies the strength of the Institute and the status of its members' (File 14-5-20). See also letter dated 26 February 1952 from F. M. Wilkinson, assistant secretary of the T&R Committee, to Lawson.

¹¹ See Appendix A for the full list of chairmen of the T&FR (T&R) Committee.

It is fully recognised that the ultimate functions of the [T&FR] Committee are advisory only, but, in view of the fact that very serious consideration is given . . . to the various questions arising and that representatives spend considerable time and trouble in attending meetings of the [T&FR] Committee and of its sub-committees, it is felt to be very desirable that the position in which the [T&FR] Committee stands towards the Council should be defined as clearly as the circumstances allow. There is no question that the authority of the Council is fully acknowledged, but it is to be feared that if the action taken by the Council on matters which have been carefully sifted by the whole organisation should differ materially from the advice tendered there is evident danger that interest and enthusiasm diminish . . . and that if the final result differs greatly from the T&FR's draft disappointment may ensue. (Ms.28432/20)

Drastic amendment to a draft memorandum from the T&R Committee, this time on 'Simplified Accounting Statements', occurred again in 1950. The T&R Committee, in accordance with normal procedure (Figure 1) submitted its draft first to the joint representatives of the P&L and T&R Committees and then, in revised form, to the P&L Committee with the clear recommendation that 'it should be issued as one of the series of the recommendations on accounting principles' (T&R Committee Minutes Book B, p. 2). At a meeting held on 25 September 1950, the P&L Committee resolved that 'a recommendation on this subject should not be issued by the Council and that the draft recommendation should be referred back to the joint representatives for redrafting in the form of *a memorandum*' (T&R Committee Minutes Book B, p. 13; Ms.28420/4, p. 187, emphasis added) which was, in due course, issued as a Council document to all members. The minutes of a meeting of the T&R Committee, held on 14 December 1950, display the depth of dissatisfaction that these actions created amongst the membership of the T&R Committee:

After further discussion, mainly on the altered and abbreviated nature of the document submitted to the Council as compared with the draft originally submitted by the Taxation and Research Committee, the following resolution was passed on a vote of thirteen in favour and eight against: that the Parliamentary and Law Committee be requested to withhold publication, in their present form, of the NOTES ON STATISTICS RELATING TO INCOME OF AND CAPITAL EMPLOYED BY COMPANIES which the Council has approved for issue to all members of the Institute pending further consideration by the original drafting sub-committee [of the T&R Committee]. (T&R Committee Minutes Book B, p. 19)

The T&R Committee's request to withhold publication of the memorandum and refer it back to the original drafting sub-committee was accepted by the P&L Committee as 'a special decision in the circumstances of this particular case and not as a precedent' (Ms.28420/4, p. 226; Council Minutes Book O, p. 215). However, in view of the Council having already decided to proceed, the memorandum was issued to members, as originally scheduled, after only minor amendment (Ms.28420/4, pp. 226, 236).

There were many other occasions when the P&L Committee was dissatisfied with the content of technical drafts emanating from the T&FR/T&R Committee. In most of these cases, the P&L Committee refrained from openly rejecting draft proposals, but nevertheless imposed its authority by returning drafts, for further

revision, until satisfied with their content (e.g., RoAP 8, *Form of Balance Sheet and Profit and Loss Account*, see Ms.28432/20). The P&L Committee also used its overriding power to place restrictions or conditions on research work undertaken by the T&FR/T&R Committee. Even more fundamentally, the P&L Committee sometimes decided to deal with matters directly, as in the case of memoranda on the content of Finance Bills, and thus avoid troublesome friction with the T&FR/T&R Committee. In relation to the series of RoAPs, the largest degree of interference occurred in the formulation of numbers 12 and 15.

DEVELOPMENT OF ROAP 12

According to Mumford (1979, p. 98; see also Tweedie and Whittington, 1984, p. 44), 'domestic inflation reached a rate of 6.7% in 1947 and 7.8% in 1948, rates unprecedented in Britain in peacetime this century'. Against this background, company directors displayed growing concern with the 'rapacious "effective rate" of corporate taxation' (Zeff, 1972, p. 17). Council was aware of these concerns with, for example, T. B. Robson, ICAEW president 1952-53 and a partner of Price Waterhouse & Co., drawing attention of the P&L Committee in 1948 to the fact that the accounting treatment of inflation was 'very much in the public eyes at the moment' and 'receiving much attention in the press' (File 12-32-1).

The issue of inflation and accounts was raised, within the ICAEW, at a meeting of the London regional T&FR Committee on 15 December 1947. E. H. Davison¹² presented a paper in which he argued that the 'great increase in the cost of capital goods which has taken place during the last eight years and is still continuing tends to throw doubt on the traditional bases of providing for depreciation and necessarily gives rise to consideration of the true object of making such provisions'. He continued:

The current methods of providing for depreciation do not take into account the fact that balance sheets and profit and loss accounts, expressed in money values, need correction for fluctuations in their standards of expression. Such corrections have, in the past, been relatively small and have consequently been ignored; fluctuations are now clearly so great that adherence to the conventional methods of provisions for depreciation may not only be misleading but dangerous... The implications of a suitable announcement by the Institute on the whole question would be very great, notably in the direction of converting the Revenue Authorities to the correct view that Profits Tax and Income Tax are being levied to an increasing extent on capital. (File 12-32-1)

In a paper previously presented at a meeting of the London and District Society of Chartered Accountants held on 19 November 1947, Davison (1947, p. 391) also stated that, 'I believe it is held, in some quarters, that the question of depreciation on a replacement basis is a matter of financial prudence or financial policy. This view is, I believe, quite clearly incorrect. The question is one of the ascertainment

¹² Davison helped Ronald Edwards of the London School of Economics set up the Accounting Research Association in 1936, and became its honorary auditor (Mumford, 1991, p. 130). Together with Basil Smallpeice, he started the London Industrial Chartered Accountants Group in February 1947.

of profit.' Davison therefore favoured reform for three reasons: to provide fully for the replacement cost of fixed assets¹³; to prevent tax being levied on capital; and to ensure that profit was a fair measure of business performance. To meet these objectives, he put forward the following recommendation for consideration by the T&FR Committee:

It is the responsibility of business management to provide for replacement of fixed assets as they fall out of use. The responsibility should be reflected in the accounts (a) by making provisions for depreciation (by whatever name called) which are adequate to ensure that the physical assets are maintained and (b) in so doing, by taking into account additional costs of replacement arising out of a rise in prices. Unless such provisions are made, profits will be overstated or, conversely, losses understated. (File 12-32-1)

T&FR Ad Hoc Sub-Committee

The president of the ICAEW, G. D. Shepherd, responded by instructing the Research Programme Sub-Committee of the T&FR Committee to consider the question of depreciation in relation to replacement costs. In due course, an ad hoc sub-committee, comprising five industrial members and one practising member, was appointed¹⁴ on 15 April 1948 to consider

The accounting treatment of amounts set aside, in addition to provisions for depreciation based on costs, to provide for the cost of replacement of fixed assets at increased prices, bearing in mind paragraph 5 of Recommendation IX¹⁵ and the following points in particular: disclosure of the fact that such amounts have been set aside, the method of calculation, whether such amounts are provisions or reserves, how the amount so set aside are to be utilised and the procedure when the asset concerned is replaced. (Various Sub-Committee Minutes Book A, p. 70)

The London regional T&FR Committee which, as we have seen, had been influential in raising the profile of the issue within the ICAEW, prepared a memorandum to serve as a starting point for the work of the ad hoc sub-committee. The memorandum argued that any amount set aside to provide for the increased replacement cost of fixed assets should be separately stated in the profit and loss

¹³ The following extract from the Report of the Tucker Committee on the Taxation of Trading Profits (April 1951, p. 7), indicates that adoption of the replacement cost basis, for financial reporting purposes, was a pre-condition for its acceptance for taxation purposes: '[t]he general scheme of the Income Tax legislation' was 'not to tax anything but income . . . and income derived from business being more usually denoted by the word "profits"', and the taxable profits were generally interpreted as 'no more and no less than the true profits of the business as computed on established accountancy principles'. However, the government appears to have been consistently opposed to inflation-adjusted accounts, with an explanation provided by Leach (1981, p. 9) when referring to the accounting profession's 1970s inflation accounting initiative: 'the Board of Inland Revenue were fearful that claims would be made to stop the taxation of inflation profits rather than real profits and thus reduce the flow of taxation'.

¹⁴ For the constitution of each relevant sub-committee or meeting, see Appendix B.

¹⁵ This stated: '[a]mounts set aside out of profits for obsolescence which cannot be foreseen or for a possible increase in the cost of replacement are matters of financial prudence. Neither can be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts' (ICAEW, 1961).

account, as a charge against earnings, and in the balance sheet as an amount credited to 'Replacement Reserve'. One of the five industrial members on the ad hoc sub-committee, F. R. M. de Paula,¹⁶ immediately made clear his staunch opposition to any proposal to charge extra depreciation 'above the line':

An increase in the price level inevitably results in a corresponding increase in the capital requirements of a business. The financing of an undertaking is the responsibility of its directors. This increased finance may be provided in various ways, i.e., by ploughing back profits, by temporary borrowing and/or by increasing fixed capital. The ultimate amount required cannot be estimated in advance. Can it be laid down that provision for this extra capital must be a charge on profits? There is nothing in the Law compelling a company to adopt the most prudent policy.¹⁷ (Ms.28432/22)

Other members appear to have been equally adamant in their support for the proposals put forward by the London regional T&FR Committee. F. Sewell Bray argued that

the economist, having foremost in mind the maintenance of productive capacity, argues that it is real assets rather than monetary capital that must be maintained intact and that depreciation provisions should be calculated with this end in view rather than on the basis of original cost. This point of view is frequently expressed by saying that real rather than money capital must be kept intact or that capital must be kept intact in real terms.¹⁸ (Ms.28432/22)

P. M. Rees, chief accountant at Lever Brothers & Unilever, also favoured basing the depreciation charge on the replacement cost of fixed assets and cited the Companies Act requirement for accounts to show a true and fair view to justify this stance (Ms.28432/22). The memorandum prepared by the ad hoc sub-committee, however, is testament to de Paula's powers of persuasion underpinned by his authoritative position within the ICAEW:

It is a principle of company accounting that capital must be kept intact. This has always been understood to mean the money capital subscribed by the proprietors . . . In a period of sharply rising prices it is obvious that if a company is to continue its operations it must either refrain from distributing its profits in full so as to conserve resources to finance future replacement, or alternatively, seek new capital when the occasion arises by either

¹⁶ As chairman of the T&FR/T&R Committee, 1943-5 (Appendix A), de Paula had naturally been closely involved in the construction of the first ten RoAPs issued, including those dealing with the valuation of stocks and fixed assets.

¹⁷ In the view of de Paula (1952, p. 521), 'the new conception of profits . . . ignored the time-honoured doctrine of historical cost and was based broadly on the assumption that both depreciation on fixed assets and inventory values should be reckoned on current replacement costs. If this new conception were adopted by the accountancy profession, it would mean that, in the past, accounts had been prepared on an incorrect basis.' In a letter to *The Accountant*, Davison (1948, p. 465) insisted that 'the last few years have shown quite clearly that accounting concepts must be revised if they are to preserve any link with reality'.

¹⁸ Bray was active within the Society of Incorporated Accountants and Auditors where he was its first Stamp-Martin Professor from 1952. According to Mumford (1983, p. 73), Bray was 'a leading replacement cost advocate' who authored a series of articles on the inflation accounting issue, published in *The Accountant* (see, e.g., Bray, 1946, 1947a, 1947b, 1948a, 1948b).

temporary borrowing or new subscriptions. These are questions of policy and the decisions made in individual cases are capable of being recorded as such in the accounts; but the accounts are essentially a record and not a programme . . . The profit and loss account should show a true and fair view of the profit or loss for the year and it may be argued that it does not do so unless the charge for usage of fixed assets is shown in the same depreciated currency as the revenue brought into account. The profit or loss, however, is *the difference between the amount for which goods or services are sold and their cost*. It is not part of the function of accounting to conjecture what might have been the result if, instead of the conditions actually experienced, the circumstances had been different either as regards the time and method of acquiring fixed assets, the time and method of fixing selling prices, the productive efficiency of the company, the value of the currency or otherwise. (Ms.28432/22, emphasis added)

Consistent with the above lines of argument, the memorandum insisted that provisions for depreciation should continue to be based on historical cost and that any amounts set aside to 'provide additional capital' for the increased cost of replacement are 'matters of financial prudence' and should be reported as 'an appropriation in the profit and loss account' and as 'a capital reserve' in the balance sheet (Ms.28432/22). The memorandum was circulated for comment to the regional T&FR committees. The London regional T&FR Committee did not 'pull its punches':

The Committee are not in favour of the issue of this document; they are not in sympathy with the general approach indicated in the preamble which savours of defence rather than of constructive proposals and they disagree with some of the statements made therein and some of the recommendations. (Ms.28432/22)

Having considered this and other comments, the ad hoc sub-committee revised the draft memorandum and presented its recommendations in the following amended form

1. That provisions for depreciation of fixed assets should continue to represent amortisation of the cost of those assets;
2. That amounts set aside out of profits to finance a possible increase in the cost of replacement of fixed assets should be stated separately in the profit and loss account and retained as a reserve in the balance sheet. (Ms.28432/22)

The previous clear statement that any amount set aside to finance the increased cost of replacement was a matter of financial prudence was deleted, while the appropriate location in the profit and loss account of any additional deduction for depreciation was rendered ambiguous by deleting the words 'as an appropriation'. It is reasonable to suspect that these changes were made to help counter further objections from regional T&FR committees, particularly London. However, the overall intention of the memorandum remained unchanged, with the explanatory section stating that '[t]he profit or loss . . . is the difference between the amount for which goods or services are sold and their *original* cost' (Ms.28432/22, emphasis added). The views of de Paula prevailed.¹⁹

¹⁹ The content of his highly influential text, *The Principles of Auditing* (10th ed., 1948), is entirely consistent with the notions expressed above.

Joint Representatives Meeting

On 17 June 1948, the T&FR Committee resolved that the memorandum prepared by its ad hoc sub-committee should be submitted, with minor amendment, to a meeting of joint representatives of the P&L and T&FR committees with the recommendation that it be published as RoAP 12. However, the joint representatives, comprising nine practising and two (Clayton²⁰ and Rees) industrial members (see Appendix B), judged the memorandum to be 'unsatisfactory' (Ms.28420/4, pp. 70–1). T. B. Robson, chairman of the P&L Committee,²¹ was particularly critical, commenting that, '[t]he more I look at the draft recommendation the greater doubt I have about it. The document seems to say the same thing as we have already said in Recommendation IX' (File 12-32-1).

It was noted above that, where the P&L Committee disagreed with proposals from the T&FR Committee, it could return the draft for further consideration. But the decision was instead made to allow the joint representatives to undertake the required revision of the T&FR Committee's document. The minutes of a meeting of the T&FR Committee, held on 14 October 1948, seem to acknowledge defeat.

It had been considered that the subject required to be treated on a wider basis than the [T&FR] committee's draft recommendation and a more comprehensive document had been prepared which was still under consideration. The changes made were such that it might be necessary for the Parliamentary and Law Committee, if it decided to submit a document to the Council, to submit it as its own and not as a T.&F.R. document. (Ms.28423, p. 150)

The industrial members of the T&FR Committee disagreed with the decision of the joint representatives to conceptualize the additional cost of replacement as a

²⁰ In addition to de Paula, Clayton was another industrial member who had no time for replacement cost accounting. See also Clayton (1950, p. 537) which argues, perhaps not unreasonably, that 'time wasted on such calculations would, I suggest, be better devoted to cash budgets to ensure that the business has or is likely to acquire sufficient cash funds to permit replacement and additions to net assets envisaged in the foreseeable future'. Clayton (1952, p. 215) supports the position adopted by RoAP 12.

²¹ Robson was a partner in Price Waterhouse & Co. who acted as joint auditor of both Courtaulds and Lever Brothers & Unilever. One might imagine there were some difficult issues for the auditors to resolve with the management of these companies which included, in the case of Courtaulds, E. H. Davison, and in the case of Lever Brothers & Unilever, P. M. Rees. The 1947 accounts of Lever Brothers & Unilever, *The Accountant* (28 August 1948, p. 180) reported: '[r]ising prices also make insufficient the normal provisions for depreciation, so a further sum has been charged representing the difference between normal rates and current replacement costs. A view is thus obtained, the directors state, of yearly profits after maintaining real capital.' The adjustments made were substantial, with the consolidated net profit, 'after setting aside the above reserves of £7,807,257', amounting to £8,512,144. Rees, as Lever's chief accountant, would certainly have approved, and may well have been instrumental in ensuring the charge was made 'above the line'. Robson's announcement that the accounting treatment of inflation was 'very much in the public eyes' (File 12-32-1) appears likely to have been triggered by the adjustment made by Lever Brothers & Unilever in its 1947 accounts. However, no mention is made of this practice in the audit report issued by Price Waterhouse & Co. until 1950 when it is stated that 'the balance shown as profit ... [is] after making the transfers to reserves'. Comparable wordings were employed in the years that followed despite the publication of RoAPs inconsistent with the practice.

matter of financial prudence and thus account for it as an appropriation of profits. In a letter to the assistant secretary of the T&FR Committee, F. M. Wilkinson, dated 19 November 1948, Rees suggested that

I have a feeling that it [the proposed document] lacks a definite recommendation as to the action—if any—an auditor should take. That is to say, whether or not he should comment in his Report if no additional amount—or, in his opinion, an inadequate amount—has been set aside out of profits to meet the position described. Can he state that the Profit & Loss Account gives a 'full and fair' view of the results if no action is taken by the company? My personal opinion is that he should comment if necessary. (File 12-32-1)

Focusing on the possible erosion of capital and the consequent risk of under-capitalization of the corporate sector, Davison's assessment of the amended draft document was even more derogatory:

The latest recommendation on accounting principles [to be] issued by the Council of the Institute will cause disappointment and dismay over a wider field than the accounting profession alone. Indeed, only the tax-gatherers are likely to welcome the recommendation since it strengthens their prerogative, for a further span, of milking industrial Capital under the guise of an 'income' tax . . . Surely the basic principle of accounting is, and always must be the truth. Profit figures, as they are now shown under conventional 'historical' accounting methods, do not reveal the whole truth, since they are based on the assumption, by now exploded, that money has a stable value . . . To arrive at a figure of 'real' profit, or indeed a figure of profit that has any meaning at all, some correction must be applied to the monetary measure. To recommend that such a correction may be applied as a matter of 'financial prudence' is to abrogate the Accountant's responsibility for stating the whole truth. (File 12-32-1)

Some practising members were sympathetic to the industrial view. For example, G. F. Saunders, partner in Harwood-Banner, Lewis & Mounsey of Liverpool, suggested to Wilkinson that

There is a considerable feeling in industry that some allowance should be made for increased replacement cost both in connection with taxation and Government costing, but if we are to bring out a recommendation asserting that the provision is merely a matter of appropriation of profit, it seems to me that we shall have great difficulty in persuading the Government to alter their views on these lines in any shape or form. (File 12-32-1)

In general, however, the practising members dismissed the industrial members' arguments on the grounds that they were too radical, politically inspired or inconsistent with accounting principles. Wilkinson, for example, described Davison as someone who held 'extreme views' and 'for whom, nothing short of the economist's method will be satisfactory'. He continued:

Personally I feel that if the Institute concedes the economist's view that a true and fair view of the profit can only be given if the usage of fixed assets is charged in depreciated currency instead of on original cost, this would represent an entire break from the principle laid down in Recommendation IX and also that specifically stated in Recommendation X [namely] 'profit or loss on trading is the difference between the amount for which goods are sold and their cost'. (File 12-32-1)

In a similar vein, G. G. G. Goult, partner in Ensor, Son & Goult of Ipswich, argued that:

I do not think that the Institute should associate itself in any of its conclusions with the present 'agitation' to charge profits with 'hypothetical' depreciation or roam into the field of economic theory . . . I cannot avoid the idea that . . . the memorandum should adhere rigidly to a concluding statement of accounting principles and not be drawn into political argument as to the remedies of the situation.

To clarify the status of any additional depreciation charge, the following amended wording was put forward at a meeting of joint representatives of the P&L and T&FR Committees held on 25 October 1948:

That any amounts set aside (in addition to provisions for depreciation based on cost) to provide for replacement of assets at increased cost should be treated as a transfer to reserve and should not, therefore, be regarded as a necessary charge in ascertaining profit. (File 12-32-1)

Despite objections from Rees, the proposal commanded majority support (File 12-32-1).

Content of RoAP 12

The P&L Committee submitted the revised document to Council with the suggestion that it be published as RoAP 12, *Rising Price Levels in Relation to Accounts*.²² Council accepted this proposal and on 5 January 1949 published RoAP 12, which stated that '[t]he following further recommendations are now made in amplification of Recommendations 9 and 10':

Any amount set aside to finance replacements (whether of fixed or current assets) at enhanced costs should not be treated as a provision which must be made before profit for the year can be ascertained, but as a transfer to reserve. If such a transfer to reserve is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately.

In order to emphasise that as a matter of prudence the amount set aside is, for the time being, regarded by the directors as not available for distribution, it should normally be treated as a specific capital reserve for increased cost of replacement of assets. For balance sheet purposes fixed assets should not, in general, be written-up on the basis of estimated replacement costs, especially in the absence of a measure of stability in the price level. (ICAEW, 1961)

The content of RoAP 12 therefore maintained consistency with the historical cost basis for published accounts previously espoused in RoAPs 9 and 10 on depreciation and stock-in-trade. The only recognition given to growing concern with the impact of rising price levels was contained in the second paragraph which, at the

²² Tweedie and Whittington (1984, p. 44) state that RoAP 12 was consistent with Accounting Research Bulletin No. 33 issued by the Committee on Accounting Procedure of the American Accounting Association in 1947 (Boer, 1966, pp. 96-7). They also point to the fact that, by the time RoAP 12 was issued, the Americans had modified their position by recommending experimentation with supplementary price-level adjusted accounts (Tweedie and Whittington, 1984, p. 38).

same time, re-asserts the primacy of the historical cost model. One can therefore conclude that the case put forward by the industrial members of the T&FR Committee was defeated by the P&L Committee which imposed its will by: (a) not referring the original document back to the T&FR Committee; and (b) amending the original draft memorandum at meetings of joint representatives of the P&L and T&FR Committees. In the estimation of Tweedie and Whittington (1984, p. 44), '[t]he rate of inflation had, by 1949, slackened, and the leaders of the profession no doubt hoped that the problem of inflation would become a purely academic issue, of no material importance to the practitioner'. If this was their expectation, it was shattered by the even steeper rising price levels caused by the rise in demand that accompanied the Korean War, 1950-52 (Morpeth, 1981, p. 43).

DEVELOPMENT OF ROAP 15

Mumford (1979, p. 101) notes that the Council of the ICAEW began its review of RoAP 12 in response to the appointment of two major government investigations into the operation of the taxation system—the Tucker Committee on the Taxation of Trading Profits in 1949, and the Royal Commission on the Taxation of Profits and Income in 1951. The review was launched, however, in response to the adoption, by influential companies such as the Imperial Chemical Industries, of new ways of accounting for fixed assets under conditions of rising price levels. *The Accountant* (5 May 1951, p. 434) reported that:

The board of directors of Imperial Chemical Industries Ltd, have announced in their preliminary statement of the trading results for 1950, that the manufacturing assets of the company and its wholly-owned manufacturing subsidiaries at home have been revalued on the basis of replacement at construction costs current on January 1st, 1950, reduced by reference to the age of the assets and their remaining useful lives. The effect in figures of this considerable task is that a surplus of £96,120,273 has been evolved and has been transferred to capital reserve . . . The reaction of other companies to this marked innovation will be watched with much interest and, in some quarters, not a little apprehension.

The joint auditors, Price Waterhouse & Co. and Thomson McLintock & Co., gave the accounts a clean report containing no mention of the upward revaluation.

Guest, Keen & Nettlefolds, whose chief accountant was W. W. Fea (a member of five of the sub-committees listed in Appendix B), announced a change to its depreciation policy in the same month. *The Accountant* (10 May 1952, p. 491) reported that 'regard had been had to the reduced purchasing power of money and the provision for depreciation had, therefore, been made on the basis of current values instead of book values of fixed assets'.

T. B. Robson informed a meeting of the P&L Committee, held towards the end of May 1951, that he had received from Sir Russell Kettle, ICAEW president 1949-50 and a partner in Deloitte, Plender, Griffiths & Co., a letter indicating that 'it may not be desirable for the Council to remain silent in view of the comments which were appearing in the press on the subject of accounting principles for dealing with depreciation, particularly since the re-valuation of assets by Imperial Chemical Industries Ltd' (P&L Committee Minutes Book E, p. 7). The

P&L Committee accordingly resolved to appoint its own sub-committee, in contrast with the normal practice of delegating such matters to the T&R Committee, to review RoAP 12 and to consider whether any further statement or recommendation should be made.

P&L Sub-Committee and T&R Ad Hoc Sub-Committee

The P&L sub-committee, consisting of four practising²³ and one industrial members (Appendix B), held its first meeting on 13 June 1951 and recommended to the P&L Committee that

the Taxation and Research Committee should be requested to submit a memorandum setting out fully the respects in which any members of the Taxation and Research Committee are not in agreement with the *principles* enunciated in Recommendation XII, the memorandum to contain the specific suggestions of those members for different principles and the reasons they give in support of their views. (P&L Committee Minutes Book E, p. 24, emphasis added)

The P&L Committee accepted this proposal (P&L Committee Minutes Book E, p. 13) and called for any dissidents to prepare, by mid-August,

a joint memorandum setting out the precise respects in which they disagreed with the recommendation and the reasons they gave in support of their views, in the form of a redraft of the whole recommendation so that the exact changes which they wished to make were made clear. (T&R Committee Minutes Book B, pp. 36–7; P&L Committee Minutes Book E, p. 13)

In spite of the very tight time scale, seven (five industrial and two practising²⁴ members, Appendix B) of the forty-eight members²⁵ of the T&R Committee met together (on 27 July and 3 August 1951) and prepared a memorandum on the points of disagreement. They suggested the following to be incorporated in a new recommendation amending RoAP 12:

1. Commence by stressing the importance of the profit and loss account, emphasising that it concerns a continuing business and that its object is to show a true and fair view of the profits or losses of an accounting period.
2. Point out that this object can be achieved only by having regard to material changes in price levels by expressing debits and credits in similar monetary units. For this purpose, revenue should be charged with the appropriate current value of assets consumed in earning it.

²³ At least one practising member, G. L. C. Touche, a partner in George A. Touche & Co., was known to be favourably inclined towards adjusting accounts for the effect of inflation. In a letter to *The Accountant* (Touche, 1948, p. 32), he had argued that 'a fundamental principle of the present accounting . . . is that profit (or increase of wealth) is the excess of selling price over historical cost (of which depreciation forms a part). The principle is manifestly untrue, since true profit (or increase of wealth) is the excess of selling price over the present value to the seller of the goods sold.'

²⁴ One of the two practising members was P. M. Rees, who had reverted to public accountancy in 1949.

²⁵ Including nineteen industrial members.

3. Distinguish clearly between: (a) the amount charged to revenue to represent the current value of assets consumed during the accounting period; and (b) any further amounts which may be appropriated out of profits to a reserve to meet the probable—but unknown—increase in future replacement cost. (Various Sub-Committee Minutes Book A, p. 187)

They also emphasized the need for the ICAEW to show it was able to address difficult technical problems and willing to provide leadership for its members:

it is inadvisable that the Institute should have issued a recommendation which admits a problem and then implies that from a practising accountant's point of view there is no recommended solution because they cannot find the answer to it. It is therefore thrown back on the directors who, in their turn, will normally refer to their own accountant who, in an increasing number of cases, is a member of the Institute and looks to it for the guidance and support which in this instance is lacking. (Various Sub-Committee Minutes Book A, p. 186)

At the time RoAP 12 was being formulated, the industrial members had placed great stress on the risk of under-capitalization resulting from failure to provide for the increased cost of replacing fixed assets in a period of rising price levels. This time, they placed centre-stage the requirement, introduced in the Companies Act 1948, for the accounts to show a true and fair view of business performance. They interpreted this requirement as giving rise to the need for asset values to be adjusted in accordance with changing price levels and for the amount charged against revenue, above the line, to represent the current values of assets consumed. Many would agree that the passage of time has demonstrated the logic of these arguments, but they appear to have had no influence on the P&L sub-committee reviewing RoAP 12 which, on 27 August 1951, emphasized the validity of RoAP 12 and resolved to prepare an 'addendum' to RoAP 12 to that effect. The P&L Committee agreed to this proposal (P&L Committee Minutes Book E, p. 28), with the role of the industrial members marginalized by delegating the work of preparing the addendum to the P&L sub-committee reviewing RoAP 12.

Politics and Principles

In preparing the addendum, the P&L sub-committee aimed for consistency, not only with the principles enunciated in RoAPs previously issued, but also with its recent and ongoing submissions to official investigations into taxation matters.

In February 1950, the ICAEW submitted a memorandum to the Tucker Committee on the Taxation of Trading Profits. The memorandum outlined ways of giving additional tax relief, for possible adoption, subject to the following condition:

whatever form of relief may be introduced to deal with the question of retained profits²⁶ or the higher cost of replacement of fixed assets, the relief should not interfere with the ascertainment of profits on accepted accounting principles; it should be an additional relief computed after the ascertainment of profits. (File 14-5-15)

²⁶ The issue here was that, in conditions of rising prices, companies were obliged to finance replacement out of retained profits that had been subject to the combined impact of income tax and profits tax.

When, two years later, the ICAEW sought to draft a memorandum for presentation to the Royal Commission on the Taxation of Profits and Income,²⁷ it was decided that such evidence 'should proceed on similar lines to that submitted by the Council to the Tucker Committee on Taxation of Trading Profits' (P&L Committee Minutes Book E, p. 46). Accordingly, the memorandum again insisted that 'the principle of historical cost must, unless and until some satisfactory alternative is available, continue of necessity to be the basis on which annual accounts are prepared for shareholders' (File 14-5-20).

The P&L sub-committee charged with responsibility for drafting an addendum to RoAP 12 held discussions with representatives of the P&L Committee responsible for preparing the submission to the Royal Commission and, following these exchanges, decided that a more extensive measure was required to deal adequately with the subject of accounting for rising price levels (P&L Committee Minutes Book E, p. 97). A new draft recommendation was prepared and submitted to the P&L Committee on 25 February 1952, but it added nothing of substance to RoAP 12. Alternatives to the historical cost basis—that is, replacement cost, current value or price index-based valuation methods—were judged to be dangerously subjective, and the conclusion reached was almost identical to that contained in the evidence presented in March 1952 to the Royal Commission: 'Unless and until some satisfactory alternative is available, the principle of historical cost . . . should continue to be the basis on which annual accounts are prepared for shareholders' (P&L Committee Minutes Book E, p. 98).

When the P&L Committee invited the T&R Committee to express its view on the draft recommendation, nineteen members voted in favour and nine against (T&R Committee Minutes Book C, p. 55). The split of votes between practising and industrial members of the T&R Committee is unknown, but we might imagine that the dissidents were mostly industrial members. Given that there were forty-eight members present, we can conclude that twenty members abstained from voting and that only a minority of the total membership voted for the draft recommendation. Hardly a ringing endorsement!

Unease with the draft new RoAP extended to members of the P&L Committee, partly it seems because of criticism of its contents from a number of organizations

²⁷ This episode in the history of the ICAEW reveals, for once, clear public evidence of disagreement, between leading chartered accountants, over important accounting issues. There existed a small number of chartered accountants, labelled the '1949 Group' (including E. K. Wright, Godfrey Judd and E. H. Davison) which 'attracted a certain notoriety within the Institute by making its own separate submission to the Royal Commission on Taxation in 1951, contradicting the official Institute view' (Mumford, 1991, p. 136). Wilkinson, in a letter to Robson dated 22 June 1951, stated that 'I have now received from Mr. Davison (one of the accountants concerned) the enclosed letter dated 20 June 1951 with a copy of the memorandum which has been sent to the Royal Commission. I do not think it calls for any action (I am sure the Royal Commission will take the same view)' (File 14-5-20). The minutes of a subsequent meeting of the P&L Committee recorded that 'the committee considered the desirability or otherwise of individual members . . . issuing documents in opposition to the published views of the Council' but it was decided not to take any further action (P&L Committee Minutes Book E, p. 18).

—the Society of Incorporated Accountants and Auditors, the Association of Certified and Corporate Accountants, the Scottish Institute, the Stock Exchange and the Federation of British Industries—that had previously requested informal discussions with the ICAEW to consider a revision of RoAP 12 (P&L Committee Minutes Book E, pp. 53–4, 62, 71). These organizations were invited to consider the new proposals at a meeting held on 21 March 1952.²⁸ A report of the P&L Committee, dated 24 March 1952, records the outcome:

With the exception of one member of the Scottish Institute, it was clear that all the representatives of other bodies disagreed with the preliminary draft document and hoped that it would not be issued. It was suggested that instead recommendation XII should be withdrawn, no further statement should be issued by the Council and that the Institute should enter into discussions with other bodies. It was evident that the main objective of the representatives of some of the other bodies was to reach the position where amounts which are treated as reserves for higher cost of replacement of assets *would be treated as charges in arriving at profits* certified by the auditors and that short of this no change would be regarded as satisfactory. (P&L Committee Minutes Book E, p. 83, emphasis added)

Certain members of the P&L Committee favoured a continuation of these discussions (P&L Committee Minutes Book E, p. 84) but a proposal to press forward and publish the draft recommendation was approved by ‘a bare majority’. Those in favour of the issue of the document argued that

- (a) There is an urgent need for guidance to members, especially in view of the amount of literature which is continually being produced on the subject, some of which tends to be special pleading and is in the nature of criticism of recommendation XII;
- (b) The Institute’s witness who will appear before the Royal Commission on the Taxation of Profits and Income will be called upon to deal with the subject, in view of the evidence which has been submitted by other bodies or persons;
- (c) At the Sixth International Congress in June, 1952, one of the main papers will deal with the subject, and it is to be presented by the President [C. P. Barrowcliff] of the Society of Incorporated Accountants and Auditors whose views are known to be contrary to recommendation XII;
- (d) There is little likelihood of reaching agreement with other accountancy bodies in the near future, in view of the public statements of their Presidents and the attitude taken by them at the recent informal discussion. (P&L Committee Minutes Book E, p. 84)

But even the ICAEW’s premier committee, comprising fourteen practitioners and just one industrial member, T. A. L. Thompson, director at Scott & Turner, Ltd, failed to achieve closure on this issue. The minutes of a meeting held on 6 May 1952 (the same month that the new RoAP was issued) record that the P&L Committee was ‘unable to reach agreement on any definite recommendation to submit to the Council on 7 May. Accordingly, it was agreed that the chairman

²⁸ The invitation was later extended to include the Association of British Chambers of Commerce and the National Institute of Social and Economic Research (P&L Committee Minutes Book E, p. 74; Council Minutes Book P, p. 10).

[Sir Harold Howitt, ICAEW president 1945–46 and a partner in Peat, Marwick, Mitchell & Co.²⁹] should report to the Council to the effect that':

- (a) the committee is divided on the question of whether the Council should issue the proposed recommendation XV;
- (b) if the Council should decide to issue the recommendation (after various amendments of the wording) then it would be appropriate for the President to make a statement at the annual meeting on the lines of the draft approved by the Parliamentary and Law Committee [proposing to invite other accountancy bodies to join in further study of the subject];
- (c) if the Council should decide not to issue the recommendation, the Council might consider [giving] the President authority to make a statement to the annual meeting on the lines of the draft approved by the Parliamentary and Law Committee. (P&L Committee Minutes Book E, pp. 86–7)

Council nevertheless resolved at a meeting held on 7 May 1952:

- (a) with three dissentients that the draft recommendation number XV on ACCOUNTING IN RELATION TO CHANGES IN THE PURCHASING POWER OF MONEY be approved . . .
- (b) with ten dissentients that the recommendation XV be issued to all members of the Institute. (Council Minutes Book P, pp. 42–3)

Content of RoAP 15

A sub-committee of the Council, consisting of Howitt, T. B. Robson, R. Kettle and Sir Harold Barton, ICAEW president 1944–45 and a partner in Barton, Mayhew & Co., settled the final form of RoAP 15 (P&L Committee Minutes Book E, p. 108) which was issued on 30 May 1952:

Unless and until a practicable and generally acceptable alternative is available, the Council recommends that the accounting principles set out below should continue to be applied:

- (a) historical cost should continue to be the basis on which annual accounts should be prepared and, in consequence, the basis on which profits shown by such accounts are computed.
- (b) any amount set aside out of profits in recognition of the effects which changes in the purchasing power of money have had on the affairs of the business (including any amount to finance the increase in the cost of replacements, whether of fixed or current assets) should be treated as a transfer to reserve and not as a charge in arriving at profits. If such a transfer is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately, since it is not the whole of the profits.

²⁹ Howitt (1952, p. 384) acknowledged the wide divergence of opinion on the issues of inflation and accounts in an address to a luncheon of members of the Incorporated Accountants' London and District Society, held on 1 April 1952: 'I will assume it is common ground that neither the accountancy profession nor industry is of one mind on the subject. It is probably true to say that these differences of opinion exist not only between members of the accountancy bodies, but even among partners of the same firm—this certainly is so in my case. In these circumstances it is very difficult for the council of any accounting body to speak with one voice as purporting to represent the views of its members—indeed this is probably impossible, and all it can hope to do is to put forward the best advice it can give, and advice which it believes to represent the majority view.'

(c) in order to emphasise that as a matter of prudence the amount so set aside is, for the time being, regarded by directors as not available for distribution, it should normally be treated as a capital reserve.

(d) for balance sheet purposes fixed assets should not (except in special circumstances, such as those referred to paragraph 12 [such as where a subsidiary is acquired and the assets are written-up to reflect the cost to the acquiring company]) be written-up, especially in the absence of monetary stability. (ICAEW, 1961)

The main thrust of RoAP 15 remained uncompromising. It is made clear that any additional deduction for depreciation should be made below the line in the profit and loss account, that the motivation for the deduction should be financial prudence, and that assets should not be written up in the balance sheet. The ICAEW nevertheless recognized the need to acknowledge the possibility of further reform, at some future date (the opening sentence in the above extract), and to leave scope for audit firms to accept the inflation accounting practices adopted by some leading companies (the last sentence of paragraph (b) and the parenthetical content of paragraph (d)).

Finally, RoAP 15 encouraged members 'who are directors or officers of companies or who are asked by clients for advice' to draw attention to the desirability of making appropriations from profit in recognition of the effects of inflation on the amount that could prudently be distributed. It also pointed to the desirability of '[e]xperimenting with methods of measuring the effects of changes in the purchasing power of money on profits and on financial statements' and referred to the possibility of publishing the results as part of the documents accompanying the annual accounts.

The image portrayed to the outside world by the ICAEW on the issue of inflation and accounts remained robust and consistent with previous pronouncements and, although acknowledging certain limitations of historical cost accounting, continued to support it ahead of all other alternatives. This apparent solidarity was achieved by silencing the dissident views expressed by industrial members and in spite of the fact that the P&L Committee, and even Council itself, contained members who were unconvinced of the validity of the party line. Zeff (1972, p. 11) informs us that endorsement of a proposed RoAP by an 'overwhelming majority of the Council' was a necessary condition for publication. Zeff (1972, p. 12) also states that, although the concept of overwhelming majority 'was never formally reduced to a specific numeral count, it was generally understood to mean a two-thirds majority' of forty-five members of the Council. The number of members present at the Council meeting of 7 May 1952 was forty-two, with three absent. Therefore, RoAP 15, with ten dissentients, only just met the criterion laid down by the Council.

There is archival evidence to show that the Board of Inland Revenue drew upon the contents of RoAPs 12 and 15 to justify the rejection of proposals, put forward by some parties in evidence submitted to the Royal Commission on the Taxation of Profits and Income, that price level adjustments should be made when computing taxable profits (File 15-5-20). Reviewing the content of RoAPs 12 and 15, the Board of Inland Revenue concluded that

This conception of the computation of profits is not accepted by the accountancy profession generally . . . Given that the new view . . . does not represent current accounting practice the general question upon which the Royal Commission may wish the Board's opinion is whether it would be proper to adopt the new view for taxation purposes alone. The Board could not support such a proposal. (File 14-5-20)

The importance of an equitable distribution of the tax burden between different categories of taxpayers was also cited by the Board of Inland Revenue to justify its preferred stance:

In considering the definition of profits which ought to be adopted for taxation purposes, the primary consideration which the Board suggest ought to be borne in mind is that of fairness as between one taxpayer and another . . . the computation of profits for tax purposes on what have hitherto been regarded as orthodox accounting principles (historical cost) is more likely to lead to fair distribution of the tax burden. (File 14-5-20)

INITIATIVES INVITED AND QUASHED, 1952–1957

RoAP 15 referred to the desirability of directors or officers of companies '[e]xperimenting with methods of measuring the effects of changes in the purchasing power of money on profits and on financial statements'. On 2 July 1952, Council instructed the T&R Committee 'to undertake research into the [above] question' (P&L Committee Minutes Book E, p. 115) subject to the restriction that 'the request does not include the question of a new conception of profit' (T&R Committee Minutes Book B, p. 60; P&L Committee Minutes Book E, p. 123; Council Minutes Book P, p. 70).

It is difficult to see how the T&R Committee could possibly address the issue without constructing a new conception of profit. Further, the P&L Committee issued the invitation 'on the understanding that the results of the Taxation and Research Committee's research may not be regarded as suitable for publication' (P&L Committee Minutes Book E, p. 123). A possible interpretation of these arrangements is that, from the outset, the P&L Committee was determined to sabotage the work of the T&R Committee. Why the T&R Committee accepted the terms of reference is unknown. Possibly, they realized that it was the only way that they could make an input to the debate and remained optimistic that they could convince the P&L Committee of the need for reform. The work was delegated to the GASC.

T&R GASC Sub-Committee

At a meeting held on 22 July 1952, the GASC appointed a drafting sub-committee consisting of three (later increased to five) industrial and three practising members (Appendix B). The sub-committee reached the tentative conclusion that an achievable objective might be to aim for an inflation-adjusted figure for profit that could be compared with the historical cost-based profit figure reported in the main accounts (GASC Minutes Book A, p. 241). The sub-committee considered various ways of adjusting expenses debited to the profit and loss account, including the possibility of applying general or specific price indices (GASC Minutes

Book A, pp. 230, 234). Consistent with Gynther's (1966, p. 45) analysis, this debate was marked by conflict between industrial and practising members (GASC Minutes Book A, p. 237). Ultimately, the drafting sub-committee was forced to acknowledge the fact that it was hamstrung by the terms of its appointment (P&L Committee Minutes Book F, p. 63):

In general the sub-committee has obtained some measure of agreement on broad principles... but attempts to apply those principles in the form of practical methods seem to infringe on matters specifically excluded [the question of a new conception of profit] from the sub-committee's terms of reference. (GASC Minutes Book A, p. 285)

The P&L Committee (25 January 1954) therefore resolved to recommend to Council that 'the terms of reference... be withdrawn' and, instead, to set the T&R Committee a second challenging task. RoAP 15 had contained the following observations concerning the limitations of historical cost accounting:

The Council cannot emphasise too strongly that the significance of accounts prepared on the basis of historical cost is subject to limitations, not the least of which is that the monetary unit in which the accounts are prepared is not a stable unit of measurement. In consequence the results shown by accounts prepared on the basis of historical cost are not a measure of increase or decrease in wealth in terms of purchasing power; nor do the results necessarily represent the amount which can prudently be regarded as available for distribution, having regard to the financial requirements of the business. Similarly the results shown by such accounts are not necessarily suitable for purposes such as price fixing, wage negotiations and taxation, unless in using them for these purposes due regard is paid to the amount of profit which has been retained in the business for its maintenance.

The P&L Committee resolved to request the T&R Committee to make suggestions designed to deal with the above limitations (P&L Committee Minutes Book F, pp. 71–2) but, again, without any apparent expectation that the task would yield productive results:

The new terms of reference be given to the Taxation and Research Committee on the understanding that it may not be considered desirable to make any publication as a result of the committee's work and that there is on this occasion serious doubt in the minds of some members of the Council as to whether the Taxation and Research Committee will be able to prepare a document which could hope to have the approval of the overwhelming majority of members of the Council which is necessary if a document is to be approved for publication. (P&L Committee Minutes Book F, p. 73)

T&R Ad Hoc Sub-Committee

The T&R Committee agreed, at a meeting held on 25 February 1954, to again accept a poisoned chalice and appointed an ad hoc sub-committee (GASC Minutes Book B, p. 3) consisting of five industrial and five practising members (Appendix B).³⁰ The approach taken by the sub-committee was to attempt to develop 'supplementary' statements that could be prepared for specific purposes (P&L Committee Minutes Book F, p. 147). The deliberations concentrated upon:

³⁰ Two industrial members and one practising member were added to the sub-committee in September 1956.

1. methods of computing profits on the basis of the replacement cost or current value of assets consumed;
2. the revaluation of fixed and current assets; and
3. the applicability of general or specific price indices when making adjustments to reflect the effects of inflation.

As before, serious disagreement arose concerning the choice of index with industrial members such as Davison and A. Rayner, director and secretary at R. W. Crabtree & Sons, Ltd, rejecting the general index in favour of one specific to a company's business (Various Sub-Committee Minutes Book B, pp. 181–2). A member of this and the previous sub-committee, J. H. Mann, a partner in Mann, Judd & Co., later summarized the depth of the problem in the following terms:

As far as I can recall some of our difficulties at that time stemmed from the tendency of industrial members like Davison to emphasise the management point of view; this raised the almost insuperable problem of finding effective generalisations to cover replacement cost, current cost and the rest. (File 12-5-16)

Joint Representatives Meeting of P&L and T&R

An interim report prepared by the T&R ad hoc sub-committee³¹ was considered at a meeting of joint representatives, held on 24 October 1956, consisting of four practising and two industrial members (Appendix B). The endeavours of the T&R ad hoc sub-committee were summarily dismissed on the grounds that its terms of reference did not include (a) the question of a new conception of 'profit for the year', (b) the determination of profit for the purposes of company law, or (c) the manner of compiling accounts for presentation to shareholders (P&L Committee Minutes Book G, p. 63).

The practitioner-dominated P&L Committee again suppressed the work of the only committee on which industrial members had significant representation. Without consultation with the T&R Committee, the P&L Committee (30 April 1957) instructed the T&R ad hoc sub-committee to suspend its operation (P&L Committee Minutes Book G, p. 82; Council Minutes Book R, p. 98) and appointed instead its own sub-committee.

MOVING TOWARDS STEWARDSHIP-ORIENTATED ACCOUNTS

P&L Sub-Committee, 30 April 1957

The minutes of the P&L Committee reveal that some of its prominent members (Sir Harold Howitt, W. H. Lawson and Sir Thomas Robson, H. A. Benson, ICAEW president 1966–67 and a partner in Cooper Brothers & Co., W. S. Carrington, ICAEW president 1955–56 and a partner in Whinney, Smith & Whinney,

³¹ The interim report suggested, among other things, that supplementary statements should be drawn up on the basis of expenditure expressed in amounts which were comparable with receipts for the period (Various Sub-Committee Minutes Book B, pp. 142–3, 154, 172).

A. S. H. Dicker, ICAEW president 1956–57 and a partner in Lovewell, Blake & Co. of Great Yarmouth, and G. F. Saunders³²) held informal meetings that led to the appointment of a new sub-committee consisting of nine practising³³ and one industrial member. The sub-committee (Appendix B) was created to address, again, the failure of directors to respond to RoAP 15's suggestion that companies should experiment with methods of measuring the effects of changes in the purchasing power of money on profits and on financial requirements. In Howitt's words: 'there is a need for the Council to give some guidance to members on methods of measuring the effects of the decline in the value of money on distributable profits' (File 12-5-16). Consistency with previously published RoAPs remained a priority, with Howitt stating that 'there was no intention to depart from the historical cost method of computing profits but rather that an amount should be set aside "below the line" for the foregoing purpose'.

This practitioner-dominated sub-committee made crystal clear its determination to address the issue from the shareholders' rather than management's point of view. The sub-committee's declared objective was to 'suggest methods of measuring the amount required in a period of inflation, in order to maintain intact the capital contributed [defined as direct contributions plus retained profit] by the shareholders' (File 12-5-16). For the purpose of deciding the amount to be set aside to maintain 'real capital' intact, the committee adopted a 'balance sheet approach'. That is, the additional amount to be appropriated out of profit would be calculated by applying a general index to the historical costs of fixed and current assets, net of liabilities, shown in balance sheet. It was also proposed that the detailed calculation should be reported in the directors' report. The sub-committee stated that it favoured applying a general index 'to ensure that an amount set aside from profits is computed on an objective basis and so not unduly influenced by the opinion of those responsible for the conduct of the business' (File 12-5-16). The sub-committee devoted considerable time and effort to the identification of an appropriate general index, entering into discussions with various experts and government bodies (P&L Committee Minutes Book G, p. 207; Book I, p. 103), but there seems to have been a lack of urgency in taking matters forward. At a meeting held on 1 March 1960, the sub-committee nevertheless confirmed its determination to fulfil its terms of reference (P&L Committee Minutes Book I, p. 88) with Mann summarizing their conclusions and aspirations as follows:

³² All except Dicker and Saunders were partners in leading London firms of chartered accountants and all except Saunders were past, current or future presidents of the ICAEW.

³³ These included S. J. Pears, ICAEW president 1960–61 and joint senior partner (with Benson) of Cooper Brothers & Co. who were one of the joint auditors for Lever Brothers & Unilever. Pears had authored a series of articles in *The Accountant* (Pears, 1949a, 1949b, 1949c) in which he stated that the most 'practicable' method of adjusting for changes in price level was the scheme used in Belgium. This involved adjusting fixed asset values based on changes in the price index, though Pears does not make it clear whether it is a general or specific price index (Pears, 1949c, p. 471).

If we leave aside all the complicated tools which management can usefully employ, we might produce something of help from the shareholders' point of view . . . If we limit our objective to indicating the amount which must be set aside in order to maintain the purchasing power of the capital employed, we might do this by comparison of balance sheets restated in terms of the closing purchasing power. (File 12-5-16)

Nothing concrete materialized and, at a meeting of the P&L Committee held on 24 April 1961, the high-profile sub-committee was disbanded.

P&L Sub-Committee, 29 May 1961

The driving force behind the reconstitution of the activities of the P&L sub-committee seems to have been Henry Benson, who had been a member of the old sub-committee and was now the chairman of the P&L Committee. He argued that 'the existing terms of reference were not likely to produce a useful result' and recommended that 'a fresh sub-committee with fresh terms of reference dealing broadly with the question of the distribution and retention of divisible profits in periods of inflation be appointed' (P&L Committee Minutes Book J, p. 132-3). The revised terms of reference of a sub-committee comprising three industrial and two practising accountants were as follows:

To prepare a memorandum for the Parliamentary and Law Committee with a view to the publication by the Council of a statement giving guidance to members on the considerations which arise in determining what appropriations should be made from profits and/or reserves, particularly having regard to the effects of inflation, to provide for replacement of fixed assets, additional working capital and other purposes before arriving at the amount which can prudently be distributed in dividends, the memorandum to include suggestions for suitable bases for computing such appropriation. (P&L Committee Minutes Book J, p. 157; Council Minutes Book T, p. 102)

It is not entirely clear, however, that there was any substantive difference between these and the earlier terms of reference. The emphasis remains on computing 'the amount which can prudently be distributed as dividends' and, as we shall see, discussion centred mainly on the use of a general price index to identify an amount to be reported 'below the line'.

The sub-committee held its first meeting on 14 July 1961 and, despite the reference to 'replacement of fixed assets', the management-oriented approach that requires the maintenance of productive capacity was unambiguously rejected:

the hypothesis that there is no disposable profit until provision has been made for 'maintenance of the business' is untenable not only because of the practical difficulties of calculating replacement costs of the fixed assets, but also because such replacement costs cannot be taken into account without also considering the effects of replacement on all the other components of total cost and possibly also on sales revenue.³⁴ (File 12-5-16)

³⁴ Fea emphasized the fact that specific price indices or replacement costs were judged irrelevant: 'the whole trend of our argument has been to say that in the Profit and Loss Account we will have nothing to do with replacement costs or costs of "maintaining the business"; all that is necessary in the Profit and Loss Account is to have all items in the cost of sales expressed in the same currency units as the sales themselves' (File 12-5-16; see also Ashton, 1987, p. 7).

The unequivocal rejection of replacement costs is surprising given that Davison—a staunch advocate of the management-oriented approach while a member of previous committees (Appendix B)—was on this sub-committee.³⁵ The sub-committee's focus, instead, on changes in the general price level was justified in the following terms:

to achieve *full comparability* in terms of the currency units used in accounts of the income and costs included in the profit and loss account of the year, what was required was merely a means of converting the expenditures brought forward from past years (or a due proportion of them) into their current equivalents in terms of purchasing power . . . The conversion of the expenditure *brought forward from past years* into its current equivalent in terms of purchasing power by the application of an appropriate price index was all that was required. (5 April 1962, P&L Committee Minutes Book K, p. 145, emphasis added)

The above extract reveals the fact that the present sub-committee differed from its predecessor in that it advocated purchasing power adjustments based on figures in the profit and loss account rather than in the balance sheet. Moreover, they appear to have been of the view, initially at least, that only certain profit and loss account items required adjustment:

In the profit and loss account the only items which are not expressed at current values are those which express the usage of physical assets including depreciation of fixed assets (which is basically an amortisation of historical cost), the charges for the use of materials, and *other cash outgo of previous years*; and therefore those are the only items of expenditure for which adjustment is required. (13 July 1962, P&L Committee Minutes Book K, pp. 190–1, emphasis added)

The sub-committee, in common with its predecessor, turned its attention to the identification of a suitable general price index, and the minutes of a meeting held on 5 April 1962 recorded that '[i]n principle, the application of a general price index to past expenditure on fixed assets, stock and work in progress and any other asset was accepted by the sub-committee as reasonable and practical' (File 12-5-16).

The logic behind the move from the balance sheet approach to the profit and loss account approach is unclear. In both cases, adjustments are based on movements in the general index and are therefore concerned with making the figures comparable in terms of purchasing power. The balance sheet approach, which involves adjusting all items (whether the adjustment is based on net assets or on shareholders' equity—the approach advocated by the previous P&L sub-committee—the outcome is the same) for changes in purchasing power, results in real

³⁵ There is no evidence that Davison had changed his mind but there does seem to have existed, at Courtaulds, differences of opinion concerning the adjustment of accounts for the effects of inflation. Davison had presented a document to the 27 July 1951 sub-committee detailing the method used in Courtaulds' management accounts to measure the effects of changes in the purchasing power of money. Its stated objective was to ascertain a correct figure of profit by charging depreciation and consumption of stock at current cost (GASC Minutes Book A, p. 266). The published accounts of Courtaulds for 1952, however, presented these adjustments as transfers of profit to reserves. According to Courtaulds' chairman, Sir John Hanbury-Williams, '[w]e prefer to regard these items . . . as appropriations rather than charges, but in any event "there can be no doubt about their necessity"' (*The Accountant*, 2 August 1952, p. 132).

capital being maintained intact. The profit and loss account approach favoured by the present committee would have resulted in only partial adjustment of shareholders' equity; it ignores expenses other than depreciation and cost of sales, it also takes no account of backlog depreciation, and it fails to consider the impact of general inflation on monetary assets and liabilities.³⁶ In short, it seems to confuse the two capital maintenance concepts—physical capital maintenance and real capital maintenance. It adjusts only the profit and loss account items that are the subject of remeasurement under certain versions of current cost/value accounting (namely cost of sales and depreciation) but uses a general price index rather than a specific price index for that purpose.³⁷

The sub-committee's interim report was considered by the P&L Committee on 25 March 1963, and the archives record that the P&L Committee tentatively 'found the line of reasoning put forward in the report acceptable in principle' (P&L Committee Minutes Book M, pp. 29–30). The chairman of the P&L Committee was, by this time, W. E. Parker of Price Waterhouse & Co.³⁸ and he began to take a close interest in the subject,³⁹ arguing that 'a full appreciation of the effect of change in the purchasing power of money can only be achieved by a revaluation of the whole share capital and reserves, assets and liabilities of the business' (File 12-5-16). Parker therefore favoured the balance sheet approach propounded by the practitioner-dominated P&L sub-committee of 30 April 1957. Correspondence and meetings between the sub-committee and Parker produced the conclusion that the balance sheet method and the profit and loss account method could be reconciled by extending the latter to deal with expenses other than depreciation and cost of sales, such as inflationary gains and losses on monetary assets and liabilities (File 12-5-16), but disagreement continued over the question of how much detail should be given. The memorandum of a meeting between the two, held on 11 March 1965, recorded that

³⁶ As noted above, there is mention of the application of a general index to 'fixed assets, stock and work in progress and *any other asset*' (emphasis added), but the main emphasis is on stocks and fixed assets, representing 'cash outgo of previous years'.

³⁷ This inconsistency is acknowledged by W. H. Lawson, a member of the 30 April 1957 P&L sub-committee, in a lecture delivered to the Liverpool Society of Chartered Accountants on 10 February 1953: 'some of those who support the index theory consider that it would be sufficient to apply the index to two items in the account only, namely, fixed assets and stock'. Lawson (1953, p. 243) continues: '[i]f it is desired to arrive at a figure reflecting as nearly as possible an increase or a decrease in wealth, which I understand to be the object of the index theory, it would seem logical to apply the index to all items in the accounts'.

³⁸ Parker was a senior partner 1965–71, ICAEW president 1967–68 and knighted for public services in 1974.

³⁹ It appears that Parker had become convinced of the merits of index adjusted accounts before the Second World War (Mumford, 1983, p. 74). Soon after his appointment as chairman of the P&L Committee, Parker authored articles on the inflation accounting issue 'from the standpoint of actual and potential equity stockholders' (Parker, 1962a, p. 568). These emphasized the need to publish 'supplementary accounts [which] also should be based on historical costs but these should be expressed in, and for that purpose translated into, monetary units of current purchasing power' (Parker, 1962b, p. 605; see also Parker, 1971, p. 716; 1975, p. 427).

the sub-committee accepted that Mr. Parker's method was a simple and direct method of arriving at a global figure for this purpose, and gave a 'control' figure ... But the members of the sub-committee stressed that in their view it was not enough only to arrive at the net overall figure. The breakdown of that figure into the underlying adjustments in respect of fixed assets, stock, and monetary assets and liabilities was essential information for a board of directors. (File 12-5-16)

Technical Committee Sub-Committee

The P&L sub-committee was reconstituted as the Technical Committee sub-committee on 24 June 1965, following the transfer of responsibility for technical matters from the T&R Committee to the newly established Technical Committee. In the following year, the sub-committee came under the jurisdiction of the newly established Research Committee on the grounds that 'any document finally prepared would be more appropriate for publication as a research document rather than as an Institute recommendation or statement of guidance' (File 12-5-16). The sub-committee was finally disbanded, in October 1966, because the resulting document was regarded as 'too complicated and too dogmatic' (File 12-5-16).

DISCUSSION AND CONCLUSION

The purpose of this article has been to examine, within the arena of inflation and accounts, issues of governance arising within a professional accounting body as the result of: the conflicting priorities of different categories of membership; the need to be seen by the state as acting in the 'public interest'; and the desire to create a public image of experts capable of successfully resolving technical issues.

Willmott *et al.* (1993, p. 69) make the important point that 'the achievement of chartered status serves to raise the material and symbolic value of their members' labour by differentiating it from that of other sellers of accounting labour, [but] the self-interested role of the trade association is, in principle, compromised and constrained'. The ICAEW's governing Council delegated responsibility for controlling the preparation of technical documents to the P&L Committee, and the need for these documents to exhibit an independent appearance, neutral to any sectional interests, was made explicit when drafting evidence for submission to the Royal Commission on Taxation of Profits and Income. By projecting the image of independent arbiter, the ICAEW sought to protect and enhance its reputation for behaving in the 'public interest'. The same priority is apparent from an examination of the work of the P&L Committee when developing RoAPs on inflation and accounts, as reflected in, for example, the argument that the ICAEW should not associate itself with "agitation" to charge profits with "hypothetical" depreciation'. In consequence, the Board of Inland Revenue, concerned to maintain equity between different categories of taxpayer and also, perhaps, keen to maximize tax revenue, was able to draw on the content of RoAPs 12 and 15 as justification for rejecting proposals for measuring business income on any basis other than historical cost. The determination to be seen to act in the 'public interest', however, brought the ICAEW into conflict with its membership, particularly those in business.

As Mumford (1991, p. 130) indicates, and this article demonstrates, members of the ICAEW were by no means unanimous in their support for the traditional, historical cost basis for published financial reports. Although there were exceptions, such as de Paula and Clayton, industrial members in general, and even some practising members of the T&FR Committee, such as Bray and Saunders, were concerned with the implications of the under-depreciation of fixed assets in a period of rising prices. They objected to the 'rapacious "effective rate" of corporate taxation', they argued that inflation-adjusted accounts provided a more meaningful profit figure and were better placed to fulfilling the Companies Act requirement for the accounts to show a true and fair view, and they rejected the idea that setting amounts aside to meet the increased cost of replacement should be considered a matter of financial prudence. Instead, they favoured charging additional, usually replacement cost-based, depreciation 'above the line'.

The arguments raised by the industrial members were labelled 'extreme' and marginalized by exclusion from the authoritative channel for the formulation of the RoAPs on inflation and accounts by the overriding power of the practitioner-dominated P&L Committee. Zeff (1972, p. 13) refers to the possibility of a technical document prepared by the T&FR Committee being completely rewritten by the Council, and we are able to confirm that the two RoAPs studied were certainly the work of the P&L Committee and Council. It needs to be remembered, however, that even the P&L Committee felt unable to approve the proposed content of RoAP 15, and the draft document failed to receive unanimous support from Council. Zeff's (1972, p. 11) assertion that RoAPs would be only published if they attracted 'an overwhelming majority'—*The Accountant* (15 January 1949, p. 33) refers to a 'substantial unanimity'—is inconsistent with our findings relating to the issue of RoAP15. The explanation for the Council's decision to press ahead and conceal internal discord may simply be that, to do otherwise, in Benson's later words, would have been 'a confession of weakness' and have risked damaging the ICAEW's competitive position in the organized market for accountants' services (File 12-43-2).

We see a paradoxical situation emerging during the period covered by this article concerning the role of the T&FR, which was initially established to help bring about improved links between members in industry and those in practice. In 1942, the ICAEW was unwilling to grant industrial accountants a place on Council, but the creation of a committee on which they had approximately equal membership went some way towards satisfying their claims for a voice in the ICAEW's decision-making processes. There is little doubt that these industrial members were in a position to make a substantial contribution to the formulation of well thought out RoAPs. As Hastings and Hinings (1970) have pointed out, however, despite common backgrounds, industrial and practising members exhibit quite different levels of attachment to shared professional values, and these differences came to the fore in the preparation of RoAPs 12 and 15. Even if the governors of the ICAEW were convinced of the case made by industrial accountants for replacement cost accounting, which they probably were not, implementation would have proved highly problematic for two reasons. First, the leadership of the ICAEW

would have had difficulty selling the case to practitioners. Second, such action might have been judged to be in breach of the ICAEW's contract with the state through its implied support for sectional interests. However, the persistent rejection of proposals put forward by industrial members did not, we suspect, help bring about the desired improvement in links between the two main sections of the ICAEW's membership.

The promotion of price level-adjusted accounting by the ICAEW would also have proved problematic in terms of the content and reputation of the, by then, well-established series of RoAPs. The previously published RoAPs, especially those dealing with tangible assets (fixed assets and stocks) had been based firmly on the concept of historical cost. To move over so soon to an entirely different measurement basis (whether based on general or specific price movements) would have risked a serious loss of credibility.⁴⁰ Therefore, adherence to traditional measurement procedures, which would naturally also have the virtue of appealing to an auditor-dominated constituency, was justified on grounds of objectivity and technical accuracy. Radical change might well have been judged also to undermine its relationship with the state for reasons other than preferment of sectional interests. The 1940s, through the series of RoAPs, had seen the ICAEW significantly extend its self-regulatory activities. Willmott *et al.* (1993, p. 71) explain the attraction of such arrangements to government:

From the standpoint of politicians and their advisors, the *economic* appeal of self-regulation lies in the non-insignificant administrative savings derived from private sector regulation of accounting labour; and its *political* appeal lies in cushioning politicians and civil servants from responsibility for any perceived failures of regulation since these can then be conveniently laid at the door of the self-regulating trade association.

There are unmistakable signs that government was impressed by the RoAP initiative. The Cohen Committee on Company Law Amendment, appointed by the Board of Trade, reported in 1945. It announced that '[t]he recent tendency has been to give more information [in published accounts] and this tendency has been fortified by the valuable recommendations published from time to time by the responsible accounting bodies' (Cohen, 1945, p. 54). For many reasons, therefore, the dominant conceptual feature of the high-profile series of RoAPs required protection.

Following the publication of RoAP15, the rates of inflation experienced in Britain up to the end of the period covered by this article were within what has been described as the 'discussion range' (Burton, 1975, p. 68), that is, 'they were sufficient to stimulate discussion of the problem by academics and thoughtful practitioners, but were not sufficiently high to create urgent demands for reform from companies or users of financial statements' (Tweedie and Whittington, 1984,

⁴⁰ RoAP 15 did, of course, encourage experimentation with methods of inflation accounting, and we have seen that subsequent committees were appointed to consider how to promote such activity. It was, perhaps, the lost opportunity for widespread experimentation between 1953 and 1968, when the level of general inflation was low, that left the profession in poor shape to cope with mounting criticism of historical cost-based financial reports when the inflation rates again began to spiral.

p. 46).⁴¹ During this period, industrial and practising members sat on a series of committees, with the industry-dominated committees appearing to be given logically impossible terms of reference. The operations of these committees were again marked by conflict between industrial and practising members that proved difficult to reconcile. Emphasis was gradually placed more and more on the stewardship role of inflation-adjusted accounts and, therefore, on the need to ensure that the real value of the shareholders' capital was protected. However, the broad acceptance elicited for general index-based accounts was accompanied by disagreement concerning the degree of detail to be provided, with industrial accountants favouring more rather than less. The internal conflict between practising and industrial members, that continued through to 1966 when the relevant sub-committee was finally disbanded, prevented the ICAEW from formulating a further RoAP on inflation and accounts.

Postscript

In 1968, *Accounting for Stewardship in a Period of Inflation* was published by the Research Committee, with the determined advocate of the 'balance sheet approach', W. E. Parker (then president of the ICAEW), described by Whittington as its 'principal author' (Whittington 1994, p. 264). The booklet advocated and illustrated 'a simple general index adjustment of historical cost accounts' (Whittington, 1994, p. 264) called current purchasing power accounting. This method formed the basis for Provisional Statement of Standard Accounting Practice 7 published in 1974 and rejected by the government-appointed *Inflation Accounting Committee* (the Sandilands Committee) that reported in the following year (1975, para. 28; Tweedie and Whittington, 1984, p. 99; Napier, 1995, p. 277). The withdrawal of PSSAP 7 was followed by experimentation with a series of replacement cost accounting models that failed to achieve acceptance for a number of reasons, including a damaging revolt by the ICAEW's own membership against the implementation of ED18 entitled *Current Cost Accounting* (1976) (Tweedie and Whittington, 1984, pp. 125–48; see also Thompson, 1987, pp. 524–8; GP&F Committee Minutes Book J, p. 61). The image of the ICAEW undoubtedly suffered as the result of its abject failure to address, effectively, the burning accounting issue of the day.⁴² It is also the case that the ICAEW's continued attempts to reconcile the different and sometimes conflicting interests of various groups of the large and growing membership proved unproductive, and the

⁴¹ The absence of general inflation in no way destroys the case for replacement cost accounting, of course, but this is probably not a view shared by practising accountants. Douglas Morpeth was ICAEW president 1972–73 and one of its leaders throughout the period when inflation raged in Britain: 'I remember Margaret Thatcher saying to me,—you're producing current cost accounting but I am going to get rid of inflation. So I said,—frankly, I would rather have no inflation than current cost accounting. And that is what happened' (quoted in Matthews and Pirie, 2001, p. 319).

⁴² The ICAEW, although responsible for launching the series of SSAPs, was soon joined in this venture by the other senior accounting bodies. It is probably true to say that the ICAEW nevertheless continued to be perceived as the professional accounting body principally responsible for guiding the content of published financial reports.

Council looked to Professor Tricker for advice on how to improve its governance arrangement (Tricker, 1983, Foreword). The Tricker Report, entitled *Governing the Institute*, was published in 1983 and commenced with the following assertion:

For many years the leadership of the Institute was unassailed. Members contentedly practised their chosen profession; tolerated their relatively autocratic leaders who, in truth, did little that affected them. Externally, too, there was little interest in, or pressure on, the Institute.

This article reveals the above to be an oversimplification of the ICAEW's history.

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APPENDIX A

CHAIRMEN OF THE P&L COMMITTEE AND T&FR (T&R) COMMITTEE

Chairmen of the P&L Committee				
Year	Name	Firms	Location	President elected
1942-44	G. R. Freeman	Gane, Jackson, Jefferys & Freeman	London	1925-26
1944-45	Sir Harold Howitt	Peat, Marwick, Mitchell & Co.	London	1945-46
1945-48	Russell Kettle	Deloitte, Plender, Griffiths & Co.	London	1949-50
1948-51	T. B. Robson	Price Waterhouse & Co.	London	1952-53
1951-52	Sir Harold Howitt	Peat, Marwick, Mitchell & Co.	London	1945-46
1952-55	W. H. Lawson	Binder, Hamlyn & Co.	London	1957-58
1955-58	G. F. Saunders	Harmood-Banner, Lewis & Mounsey	Liverpool	
1958-59	S. J. Pears	Cooper Brothers & Co.	London	1960-61
1959-62	H. A. Benson	Cooper Brothers & Co.	London	1966-67
1962-65	W. E. Parker	Price Waterhouse & Co.	London	1967-68

Source: Ms.28420/4; P&L Committee Minutes Books E–P.

ABACUS

Chairmen of the T&FR (T&R) Committee				
Year	Name	Position of industrial members	Firms	Location
1942-43	H. M. Barton		Barton, Mayhew & Co.	London
1943-45	F. R. M. de Paula	Vice-chairman and general manager	Harding, Tilton & Hartley, Ltd	London
1945-46	H. J. Page		Kemp, Chatteris & Co.	London
1946-48	P. M. Rees	Chief accountant	Lever Brothers & Unilever, Ltd	London
1948-49	G. F. Saunders		Harmood-Banner, Lewis & Mounsey	Liverpool
1949-50	J. Clayton	Director	Broadcast Relay Service Ltd	London
1950-51	W. G. Campbell		Josolyne, Miles, Page & Co.	London
1951-52	W. W. Fea	Chief accountant	Guest, Keen & Nettlefolds, Ltd	Birmingham
1952-53	G. G. G. Goult		Ensor, Son & Goult	Ipswich
1953-54	G. S. Hamilton	General manager	Bass, Ratcliff & Gretton, Ltd	London
1954-55	T. Fleming Birch		A. C. Palmer & Co.	Leicester
1955-56	J. Latham	Director general of finance	National Coal Board	London
1956-57	G. P. Morgan-Jones		Edmonds & Co.	Eastbourne
1957-58	Stanley Dixon	Director	The Midland Tar Distillers, Ltd	Birmingham
1958-59	E. N. Macdonald		Chalmers, Wade & Co.	Liverpool
1959-60	A. H. Proud	Director	Bourne & Hollingworth, Ltd	London
1960-61	G. N. Hunter		Theodore B. Jones & Co.	Leeds
1961-62	J. Cartner	Director	The Metal Box Co., Ltd	London
1962-63	S. M. Duncan		Price Waterhouse & Co.	London
1963-64	H. C. Shaw	Director	Reckitt & Coleman Holdings, Ltd	Hull
1964-65	Stanley Kitchen		Foster & Stephens	Birmingham
1965-66	D. W. Robertson		Tarquand, Youngs & Co.	London

Source: Ms.28423; T&R Committee Minutes Books B-D.

APPENDIX B

MEMBERSHIP OF THE RELEVANT SUB-COMMITTEES OR MEETINGS

15 April 1948	28 June 1948	13 June 1951	27 July 1951	22 July 1952	25 February 1954	24 October 1956	30 April 1957	29 May 1961	24 June 1965
T&FR ad hoc sub-com.	Joint reps. meeting of P&L/T&FR	P&L sub-com.	T&R ad hoc sub-com.	T&R GASC sub-com.	T&R ad hoc sub-com.	Joint reps. meeting of P&L/T&R	P&L sub-com.	P&L sub-com.	Technical Committee sub-com.
<i>Industrial</i>									
F. R. M. de Paula									
W. W. Fea			W. W. Fea	W. W. Fea				W. W. Fea	W. W. Fea
P. V. Roberts							P. V. Roberts		
P. M. Rees	P. M. Rees		P. M. Rees (In practice)						
	J. Clayton				J. Clayton	J. Clayton			
		K. A. E. Moore							
			A. P. Ravenhill	A. P. Ravenhill					
			J. Cartner	J. Cartner	J. Cartner	J. Cartner			
			E. H. Davison	E. H. Davison	E. H. Davison			E. H. Davison	E. H. Davison
			H. Norris						
				J. R. Cuthbertson	J. R. Cuthbertson				
				D. de Rosario	D. de Rosario				
					G. S. Hamilton				
					C. W. Aston			C. W. Aston	
					A. Rayner				
									D. C. Urry

APPENDIX B

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ROBERT P. GRAY AND FRANK L. CLARKE

A Methodology for Calculating the Allowance for Loan Losses in Commercial Banks

Severe disturbances in the financial markets in many countries during the 1980s and 1990s caused many stakeholders to examine whether commercial banks had adequate reserves for future loan losses. In the United States, bank regulators considered an adequate Allowance for Loan Losses a 'safety and soundness' issue while the SEC became increasingly concerned over the possibility of banks using the Allowance as a method to 'manage earnings'. Both regulators demanded more rigorous calculations from banks to support their accounting entries. Also the FASB and the IASB have expressed concerns about a lack of harmonization and convergence in standards. An analysis of measurement standards in the United States, Canada, Japan, the United Kingdom and Australia, as well as by the Basel Committee on Banking Supervision and the IASB, reveals the partially conflicting goals for the Allowance: (a) promote harmonization (IASB), (b) increase transparency (SEC), (c) promote safety and soundness (bank regulators) and (d) maintain reasonable flexibility in recognition of the subjective aspects in determining an appropriate Allowance (bankers). The article offers a methodology which an individual bank may utilize to reconcile the conflicting goals of all interested parties.

Key words: Accounting; Allowance; Banks; Earnings management; Provision.

In a commercial bank the Allowance for Loan Losses (also known as the Reserve for Loan Losses, hereinafter the Allowance) is considered to be the primary vehicle for earnings management. The Allowance is the contra-asset account used to adjust the principal value of gross loans for the expectations of future credit losses (Wahlen, 1994). Since it is replenished by a charge to earnings (Provision for Loan Losses) and the credit quality of the loan portfolio cannot be determined precisely by objective criteria, the Allowance has been shown potentially as a means to manage earnings.

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This article analyses the different viewpoints taken regarding the measurement of the Allowance by different interested parties—bank regulators, accounting standard setters and banks. Additionally, the measurement standards in the U.S., U.K., Canada, Japan and Australia, by the Basel Committee on Banking Supervision and the IASB are detailed. Conflicts between such issues as ‘safety and soundness’ and ‘earnings management’ are identified and a methodology satisfying the requirements to reconcile the conflicting goals of all interested parties is offered.

The Securities and Exchange Commission (SEC) in 1998 publicly branded the practice of earnings management improper (Levitt, 1998). Financial sagas since then in the U.S.A. and elsewhere have reinforced that position. Given the size and potentially discretionary aspects of the Allowance and the temptation by bank management either to smooth earnings or use the ‘big bath’ technique, conflicts among various interested parties in the measurement of the Allowance assume major importance, even to the extent of being a subject of U.S. Congressional hearings (Roukema, 1999). The Basel Committee identified credit risk as the ‘leading source of problems in banks world-wide’, thereby heightening the importance of measuring the potential losses in a bank’s loan portfolio (Basel Committee, 2000a, p. 1). Furthermore, the Basel Committee stated in *Best Practices for Credit Risk Disclosure*: ‘A bank should disclose information on the accounting policies and methods it uses to determine specific and general [unallocated] Allowances, and it should explain the key assumptions it uses’ (Basel Committee, 2000b, p. 8). Clearly, any material differences in Allowance measurement techniques are of concern to the Basel Committee, and, as shall be shown, also to others. This article demonstrates that there are conflicting viewpoints concerning the measurement of the Allowance that need to be reconciled: among different regulators in different countries, and among bank regulators, accounting standard setters and bankers within a country. Reconciliation is necessary to meet the objective of the Basel Committee that: ‘Market participants and other users need information that can be compared across institutions and countries, and over time’ (Basel Committee, 2000b, p. 6).

THE ALLOWANCE FOR LOAN LOSSES AND EARNINGS MANAGEMENT

After the disastrous savings and loan experience in the United States in the 1980s, considerable pressure was placed on banks by banking regulators to maintain adequate (often defined as large) Allowances. This was consistent with regulatory conservatism and was in response to demands for banks to make larger provisions for possible bad and doubtful debts, even in times when they might from a reported profit perspective be least able to do so. However, pressure also arose when banks were found to be overproviding and thus violating SFAC 2 which states, ‘The Board emphasizes that point [conservatism should no longer connote deliberate, consistent understatement of net assets and profits] because conservatism has long been identified with the idea that deliberate understatement is a

virtue' (FASB, 1980, para. 93). For example, in 1997 the SEC criticized banks for maintaining excessive Allowances (Sutton, 1997), perhaps implicitly stating that some banks' practices entailed earnings management—resulting in the use of the term 'secret reserves' reappearing.

To digress briefly, this reporting phenomenon is evident elsewhere. Healy and Wahlen (1999, p. 368) observe that, 'Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers'. Since at least 1981, there has been considerable speculation that commercial banks use the Allowance to manage earnings (Scheiner, 1981). Healy and Wahlen (1999) survey the earnings management literature and align the research with the setting of accounting standards. Katz (1999–2000, p. 53) notes that: 'The loan-loss reserve issue is only the most visible manifestation of the SEC's broader campaign to address what it sees as a growing and potential harmful practice of managing earnings, a technique allegedly used by publicly traded companies to smooth out financial results from quarter to quarter'. Of course, post-Enron allegations of 'accounting irregularities' have further highlighted the need to better understand earnings management practices.¹

Two early potential incentives for earnings management were identified in the literature: (a) income smoothing to reduce income variance, thereby enhancing shareholder value, and (b) earnings management to maximize executive compensation based on thresholds of corporate earnings (McNichols and Wilson, 1988; Bhat, 1996). Ma (1988) tied the income smoothing hypothesis to commercial banking and the Allowance. Ahmed *et al.* (1999) hypothesize signalling effects in the management of bank earnings through the Allowance. Their work augmented that of Wahlen (1994). Koch and Wall (2000, p. 3) hypothesized four different incentives to manage earnings through the Allowance: '(1) Smooth Income, (2) Occasional Big Bath, (3) Live for Today, and (4) Maximize Variability'.

Beatty *et al.* (2002) test Burgstahler and Dichev's (1997) conclusions that firms report small declines in earnings less frequently than small increases by comparing the results of privately held banks and public banks. Support was found that publicly held banks manage earnings to avoid earnings declines.

When determining an appropriate amount for the Allowance, given the condition of a bank's loan portfolio, the Allowance is considered to have two parts: non-discretionary and discretionary (also called unallocated). The non-discretionary part is a function of specific quality determinants in the loan portfolio—non-accrual loans, renegotiated loans, loans past due over ninety days and specific analyses on troubled large credits, usually employing internal grading systems. A key issue has arisen concerning whether, at least in the U.S., the discretionary portion is allowable since 'FASB Statements 5 and 114 require that the Allowances be

¹ Readers should refer to the May 2000 special issue of *Journal of Accounting Research*, 'Studies on Financial Reporting Disclosure and Corporate Governance', as well as the scale of 'accounting irregularities' in the new millennium. The latter are reported on the SEC website.

provided for losses that have been incurred as of the balance sheet date' (Sutton, 1997, p. 4).

Developing a methodology for calculating the Allowance is critical for a commercial bank and its regulators as: bank loan portfolios are often over ten times the amount of bank equity (Wahlen, 1994), loan losses are the dominant reason for bank failures (Basel Committee, 1998), and the Allowance has a direct effect on a bank's reported earnings.

CURRENT STANDARDS

A key issue in analysing a country's standards in relation to the Allowance is how the allocation of potential loan losses that are not determined by analyses of specific loans (the unallocated portion of the Allowance) is prescribed in particular countries. This brief review highlights the partially conflicting regulatory goals. An extensive coverage of the issues debated in the U.S. is followed by lesser analyses of similar debates in several countries.

The United States

Disasters in the savings and loan industry and distress in the commercial banking industry in the 1980s and early 1990s caused a re-evaluation of the adequacy of the Allowance for Loan Losses in many banks and thrifts. In particular, Regulatory Accounting Principles (RAP) as used in the savings and loan industry were severely criticized for being misleading (Kane, 1989). In response to these and other concerns Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) which stated that a banking regulator may prescribe an accounting principle different from GAAP *if* GAAP is inconsistent with the accounting objectives of the Act (accurate reflection of capital, effective supervision and ability to facilitate prompt corrective action of problem institutions) *and provided* such RAP are no less stringent than GAAP (FDICIA, Title 1, Subtitle C, Section 121). The bank regulators' main concern became whether the Allowance was adequate, not whether it was overstated. Thus the regulators' incentive was to bias the Allowance upward due to bank failures reflecting negatively on regulatory performance both with the Congress and the general public.

On 7 November 1997, Chief Accountant for the SEC, Michael H. Sutton, stated: 'We have received a number of inquiries, both domestically and internationally, that suggest that Allowances for loan losses reported by some U.S. banks may be overstated' (Sutton, 1997). The Allowance, which had been receiving decreasing attention from the media and from bank regulators by virtue of the drastic reduction in bank failures in the United States,² had thus again become a controversial accounting issue. Many bankers had thought that high Allowances

² U.S. bank failures declined from 206 commercial banks in 1989 with \$24 billion in deposits and 124 commercial banks in 1991 with \$53 billion in deposits to three banks in 2002 with \$.904 billion in deposits (Federal Deposit Insurance Corporation, 2004).

would not be criticized due to 'safety and soundness' issues and the general accounting principle of conservatism. The controversy escalated dramatically in 1998 when the SEC questioned the Allowance of SunTrust Banks, Inc. in respect to a proposed acquisition of Crestar Financial Corporation. The SEC claimed that SunTrust had a larger than permitted Allowance under U.S. GAAP rules and had therefore understated earnings.³ Accordingly, SunTrust was forced to restate prior years' statements (Wall and Koch, 2000).

This accounting controversy resulted in testimony in Congress from representatives of the SEC, FASB, various bankers' associations and the regulators of U.S. financial institutions. All parties agreed that FASB standards should dominate; however, the groups differed on their interpretation of the existing FASB standards: SFAS 5 (1975), *Accounting for Contingencies*; and SFAS 114 (1993), *Accounting by Creditors for Impairment of a Loan*.

On 6 July 2001 the SEC (SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*) and the Federal Financial Institutions Examination Council (FFIEC) on behalf of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency and the Office of Thrift Supervision ('Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings and Institutions', FFEIC, 2001, p. 35629) stated their joint position on the Allowance. There had been little controversy concerning the application of FAS 114, which identifies three different methodologies for measuring impairment for a loan to be analysed individually. The controversy had focused on loans evaluated on a group basis under SFAS 5 (1975). Loans were to be segmented 'by identifying risk characteristics that are common to groups of loans' (FFEIC, 2001, p. 35634). Furthermore the FFEIC (2001, p. 35636) stated, 'An institution's ALLL [Allowance] methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio'. Therefore the focus was on the accuracy of the estimate, regardless of the accounting methods used to achieve that method; importantly the U.S. had accepted the idea of an unallocated portion provided the application was rigorous.

More recently the Accounting Standards Executive Committee (AcSEC) of the AICPA issued on 15 February 2002 a proposed statement of position (SOP) on the Allowance for Credit Losses. This proposed SOP repeatedly emphasizes that judgment rather than a strict mathematical calculation is necessary in determining an appropriate Allowance. While maintaining the concept that impairment should not be recognized before it is probable, the SOP states that 'the creditor should take into account all available information about conditions existing at the balance sheet date, including credit quality, current trends (that are indicative of current conditions and not projections), and existing environmental factors (for example, industry, geographical, and economic factors)' (AcSEC, 2002, p. 20). Pooling loans which have similar risk characteristics is described. On 9 January

³ This over-provisioning and creation of a potential 'secret reserve' is reminiscent of the 1920s U.K. Royal Mail cause célèbre (see Green and Moss, 1982).

2003 the FASB met and recommended that FASB staff work with AcSEC 'to incorporate Board members' and staff's suggestions into the SOP (FASB, 2003, p. 4).⁴

Canada

The Bank of Canada stated, as of December 2002, loan-loss provisioning includes the 'use of general provisions' (Bank of Canada, 2002, p. 6). They also noted that timeliness had been improved. In 1992 banks in Canada reported according to RAP since there were no GAAP for banks in Canada (Cockburn, 1992). By 2002 GAAP was required for Canadian banks (Bank Act, 1991, para. 308 (4)).

Great Britain

The Bank of England states that information for management 'should be prepared to provide an analysis of assets and liabilities showing how they have been valued' (Bank of England, 2001, AR7). Hoggarth and Pain (2002, p. 177) show that loan losses could be affected by macroeconomic events thereby implicitly arguing for a general provision that includes events and measurements external to a bank's loan portfolio even though 'provisions for loan losses are normally made only after a default event has occurred'. They cite Borio *et al.* (2001, p. 6), who show that the risk in a loan portfolio can increase in an economic expansion because, 'if output is above trend, the (conditional) probability of a downswing increases with the forecast horizon'. Thus the Bank of England recognizes the need for general Allocations while noting the accounting conventions of adding to provisions upon defaults (a very restrictive standard).

Japan

The Japanese government required that 'Prompt Corrective Action' be implemented by April 1998 (Bank of Japan, 1998). Significantly, rather than prescribe a method, Japan requires that 'financial institutions conduct adequate assessment of their assets and calculate appropriate "loan-loss write-offs and provisions" based on their own internal rules' (Bank of Japan, 1998, p. 1). The bank then describes in detail a method it is introducing for commercial bank consideration—the tracing method (which is similar to the U.S. migration method which tracks individual loan performance over time). From empirical studies, they also state four points that result in enhancing the accuracy of the technique. The technique specifically provides for a provision for assets graded 'nonclassified', that is, there is no discernable weakness. Thus Japan is recommending the essence of a general Allocation with more guidance than is given in other countries.

Japan uses RAP for banks as prescribed by the Ministry of Finance rather than the accounting principles in the Commercial Law of Japan (Wallison, 2001).

⁴ Pursuant to the goal of moving toward a single accounting standard setter in the United States for the private sector, the AICPA and the FASB have agreed that no additional SOPs will be issued by AcSEC.

Australia

The Australian Prudential Regulatory Authority (2002, p. 2) has specified that depository institutions 'establish provision to address latent losses known to exist in its credit portfolio but which cannot be ascribed to individual facilities'. General Allocations together with frequent analyses are known as dynamic provisioning. The major Australian banks adopted this system but did not do so in the same accounting period, causing difficulties in comparing results between banks. (Westpac Banking Corporation adopted dynamic provisioning in 1994 while another major Australian bank, National Australia Bank, adopted it in 1998.) The change to dynamic provisioning caused large, one-time increases in the Allocation.⁵

Australia has no separate RAP for banks; rather it incorporates specific disclosures for financial institutions within Applicable Accounting Standards in AASB 1032, *Specific Disclosures by Financial Institutions* (1996).

International Developments

The pronouncements of the Basel Committee, which was established by the central bank governors of ten large developed countries, do not have the weight of law but have significant influence on the Bank of International Settlements and individual countries' bank regulators. The Basel Committee does not specifically recommend an Allocation method, rather noting that information should be provided to determine 'how the Allocated and (any) unallocated portions of the Allowances are determined' (Basel Committee, 2000b, p. 9).

Basel Committee (2000a, p. 2) states that all members of the committee agreed to all of the general principles listed in *Principles for the Management of Credit Risk*, including that banks shall conduct monitoring in order to maintain 'adequate reserves for credit losses' (Basel Committee, 2000a, p. 14).

In moving toward a New Basel Accord, commonly known as Basel II, the Basel Committee offers more detailed guidance on provisions (Basel Committee, 2003). Three approaches are allowed: (a) the Standardized Approach which is similar to the present Basel Accord, (b) the Foundation Internal Ratings-Based (IRB) approach and (c) the Advanced IRB approach. Both IRB approaches use the banks' internal assessments as key inputs for calculations with the Advanced IRB approach using more bank inputs and the Foundation IRB using less.

As organizations, the Bank of International Settlements and the European Central Bank are silent on the issue of whether general allocations are 'proper' from an accounting standpoint.

Since the goals of the IASB are harmonization and convergence, it supports a set of GAAP for banks being incorporated in the International Accounting Standards. It presently has a project in process to develop a disclosure draft on 'Activities of financial institutions: disclosures and presentation' (IASB, 2003).

⁵ For example, National Australia Bank's charge was \$369 million partially offset with a tax credit of \$124 million (National Australia Bank, 1998, p. 82).

CONFLICTING AND INTERSECTING GOALS OF INTERESTED PARTIES

Four stakeholders for policy determination on the Allowance (the international accounting community, U.S. accountants, bank regulators and bankers) have different goals and somewhat different biases. The goals and biases, which partially conflict and partially support each other, are summarized in Table 1:

TABLE 1

GOALS OF FOUR CONSTITUENCIES OF THE ALLOWANCE FOR LOAN LOSSES

Group	Proxy(ies)	Goal(s)	Bias on allowance
International accounting community	IASB	Harmonization	Neutral
U.S. accounting community	SEC, AICPA, FASB	Transparency	Lower
Bank regulators	Federal Reserve, FDIC, central banks	Safety and soundness	Higher
Commercial bankers	American Bankers Association	Shareholder value	Flexibility

International Accounting Community

The Basel Committee (1998, p. 6) states the following objective, 'To promote convergence of policies and practices across banks and countries'. The International Accounting Standards Board⁶ stated in its conceptual framework: 'The IASB Framework assists the IASB: . . . in promoting the harmonization of regulations, accounting standards and procedures' (IASB, 2001, p. 1). To assist in making the financial statements of banks comparable throughout the world, the IASB has issued two standards: (a) IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* (1990), and (b) IAS 36, *Impairment of Assets* (1998).

In order to reconcile the differing aims of the accounting professions of different countries and to achieve harmonization, International Accounting Standards (IASs) are necessarily quite general. For example, the 'Fundamental Requirement of IAS 36' (Impairment of Assets) states: 'An impairment loss should be recognized whenever the recoverable amount of an asset is less than its carrying amount (sometimes called "book value")' (IASC, 1998). The difficulty in harmonizing standards is exemplified in the controversy and lengthy gestation period devoted to formulating IAS 39 (1998), *Financial Instruments: Recognition and Measurement*.⁷

⁶ Formerly the International Accounting Standards Committee.

⁷ See, for example, Gray (2003).

U.S. Accounting Community

Transparency is the stated goal of the SEC (see Nazareth, 2002, and many others). Disclosure is the *sine qua non* of the SEC. The U.S. accounting profession's goal of transparency does not necessarily conflict with IASB's goal of harmonization; however, harmonization is easier to obtain by having standards that are more general.

The U.S. accounting profession, and specifically the SEC, has sought to limit the size of the discretionary Allowance and hence the size of the Allowance since it is the discretionary portion of the Allowance that has greatest potential for earnings management. Therefore the SEC has a bias toward a smaller Allowance.

U.S. Bank Regulators The bank regulators view the Allowance as a 'safety and soundness' issue. Director of the Federal Reserve's Division of Banking Supervision and Regulation, Richard Spillenkothen, observed, 'From a safety and soundness perspective, the Federal Reserve and other bank regulators have expected institutions to maintain strong loan loss reserves that are conservatively measured' (1999, p. 2). This statement can be construed to mean the Federal Reserve prefers a large Allowance.

Commercial Bankers Commercial bankers have as a primary goal the maximization of shareholder value since (a) shareholder value is a significant way to measure the success of the company and, therefore, the company's management, and (b) a significant percentage of executive remuneration entails issuing stock options to top management. Management therefore has an incentive to use earnings management techniques, such as income smoothing, to the extent that altering profits increases share prices. Barth *et al.* (1999) demonstrate that firms with a consistent pattern of increasing earnings over time have higher price-earnings multiples than other firms with more variable earnings patterns. DeAngelo *et al.* (1996, p. 359) documents that a break in the increasing earnings pattern tends to cause a 'statistically significant abnormal return of -13.96%'.

DeGeorge *et al.* (1999) discusses the management of earnings to attain thresholds. Examples of such thresholds are 'report positive profits, sustain recent performance, and meet analysts' expectations' (DeGeorge *et al.*, 1999, p. 30).

Furthermore, when a commercial bank appoints a new CEO, particularly one from outside the company, there is an incentive for that executive to identify all possible loan losses and to increase the Allowance so that future earnings would reflect well on the CEO—the 'big bath' technique.

Given an apparent desire by many executives to have constantly increasing earnings and to not be held responsible for the poor performance of prior management, commercial bank executives have a bias toward flexibility on the Allowance.

RECONCILIATION OF THE GOALS OF THE FOUR GROUPS

International accountants, bank regulators and U.S. accountants all state that earnings management is improper accounting and should not be permitted. This

is likely to be more strongly emphasized post-Enron. Likewise, all three regulators believe that transparency in accounting treatment is desirable. Although the international accounting bodies appear to emphasize harmonization more than their U.S. counterparts, the latter are not against that goal. The difficulty is agreeing on the standards countries will use. For banks, the main controversy arises in the area of flexibility in determining the Allowance. This flexibility is manifested through the calculation of the unallocated (discretionary) portion of the Allowance. Examples of components in the unallocated portion include:

1. Qualitative factors, 'e.g. industry, geographical, economic and political factors' (FFEIC, 2001, p. 35629).
2. Statistical analyses of loans not individually analysed for a special reserve and therefore not subject to FAS 114. Examples of techniques that have been employed are Japan's tracing method and migration analysis measuring the probability of loans in different classes or pools migrating to loss (Austin, 1992).

In order to reconcile the goals of the interested parties, a method is needed to promote harmonization (IASB), increase transparency (SEC), promote safety and soundness (bank regulators) and maintain reasonable flexibility in recognition of the subjective aspects in determining an appropriate Allowance (bankers). A methodology which meets these objectives follows. It incorporates qualitative factors and a rigorous methodology for statistically analysing loans without a special reserve.

A PROPOSED METHODOLOGY FOR THE ALLOWANCE FOR LOAN LOSSES

Allowance for a bank is depleted and replenished by the following formula:

$$ALL_t = ALL_{t-1} + PROV_t + RECOV_t - CO_t \quad (1)$$

where, ALL = Allowance for Loan Losses,

$PROV$ = provision for Loans Losses (an expense account),

$RECOV$ = recoveries of the principal amount of loans charged off in previous accounting periods,

CO = principal amount of loans charged off,

t = date of the calculation of the reserve, and

$t - 1$ = Date of the end of the previous reporting period.

When determining what is an appropriate amount for the Allowance for Loan Losses, given the condition of a bank's loan portfolio, the Allowance is considered to have two parts: non-discretionary and discretionary. The non-discretionary part is a function of specific quality determinants in the loan portfolio—non-accrual loans, renegotiated loans, loans past due over ninety days and specific analyses on troubled large credits, usually employing internal grading systems. A significant problem for researchers has been in segregating the 'discretionary' portion of the

CALCULATING BANKS' LOAN LOSS ALLOWANCE

Allowance for Loan Losses. A methodology for determining the ALL which would reduce the discretionary portion relative to the non-discretionary portion would tend to mitigate the opportunities for earnings management.

The ALL, as a valuation reserve, is an adjustment to gross loans entirely for credit risk. Opportunity cost and interest rate risk are not considered. As such, the true Allowance (ALL_t) is defined as:

$$ALL_t = \sum_{x=t}^{\infty} (LLGROSSLOANS)_x \quad (2)$$

where ALL_t = Allowance for Loan Losses at time t , and
 $LLGROSSLOANS$ = loan losses from gross loans indicated.

Therefore the ALL is meant to capture the future losses in an existing portfolio. In order to estimate those future losses for an individual bank the following regression equation is proposed:

$$ALL_t = \beta_0 + \beta_1 PORTFOLIO_t + \beta_2 OBS_t + \beta_3 CONCENG_t + \beta_4 CONCENI_t + \beta_5 ECONL_t + \beta_6 ECONN_t + \epsilon_t \quad (3)$$

where, at time t :

ALL_t = estimated Allowance for Loan Losses,
 $PORTFOLIO_t$ = the existing loan portfolio,
 OBS_t = credit losses associated with off-balance-sheet credit instruments,
 such as standby lines of credit,
 $CONCENG_t$ = geographic concentration risk,
 $CONCENI_t$ = industry concentration risk,
 $ECONL_t$ = economic conditions in the local market, and
 $ECONN_t$ = economic conditions in the national market.

$PORTFOLIO$ and OBS correspond to the non-discretionary portion of the ALL since, as will be shown, they are calculated directly from current and historical financial statement data. The remaining terms are discretionary, and therefore subject to potential earnings management.

In order to develop OLS coefficients, one must know what the ALL *should have been*. Therefore, at any time a bank must draw on historical information to develop the ALL for various years. Typically,⁸ a five-year data period is needed to ascertain which loans from an existing portfolio migrated to loss. This time period is indicative of the remaining maturities of the loan portfolio. If a commercial bank had a shorter term portfolio, a period less than five years may be appropriate. Therefore the most current ALL_t , which reflects the future loss history of the loan portfolio, is, in the above example, five years old. From that year, and previous years, the coefficients are estimated and used for the calculation of the most appropriate Allowance for Loan Losses in the *current* year, according to equation (4).

⁸ This fact draws upon the experience of one of the authors as a bank CEO in the U.S.

$$ALL_t = \beta_0 + \beta_1 PORTFOLIO_t + \beta_2 OBS_t + \beta_3 CONCENG_t + \beta_4 CONCENI_t + \beta_5 ECONL_t + \beta_6 ECONN_t + \epsilon_t \quad (4)$$

where ALL_t is an *estimate* for the true ALL_t (which will only be known with precision when it is determined which loans migrated to loss).

Thus, ALL_t becomes the Allowance for the bank to use, based on its own historical data, for financial reporting as per equation (1).

Multivariate regression models are based on a number of rather strict assumptions, such as multivariate normality. After a bank obtains its own data, its regression model would have to be tested for these issues. Additionally, a test for multicollinearity would need to be conducted and variables eliminated, if appropriate.

This would be the proposed methodology for developing estimates for the discretionary components.

Risk in the Existing Loan Portfolio

The non-discretionary portion of the ALL is divided between $PORTFOLIO_t$ and OBS_t . From equation (5), $PORTFOLIO_t$ is measured by:

$$PORTFOLIO_t = SPECIALALL_t + CC_t + CONS_t + NOALL_t \quad (5)$$

where, at time t :

$SPECIALALL_t$ = the Allowance for Loan Losses for which special allowances have been applied,

CC_t = those credit card accounts past due more than 180 days,⁹

$CONS_t$ = those consumer loan accounts past due more than 120 days, and

$NOALL_t$ = allowance requirements to be determined for larger loans without a special allowance. These are the loans for which a Markov chain theory technique will be used. They contain the loans presently under contention among the U.S. bank regulators, the SEC and the bankers.

Loans for Which a Special Allowance Has Been Allocated

A 'loan becomes "impaired" when it is probable that the bank will not collect all the interest and principal according to original contractual terms' (Altman, 1993, p. 10) and therefore falls under SFAS 114, *Accounting by Creditors for Impairment of a Loan* (FASB, 1993). On a practical basis, these are relatively large loans in a bank and merit special and individual attention in determining an appropriate Allowance. Three different methods are available: (a) present value of expected future cash flows, (b) fair value of collateral, and (c) observable market price of the loan.

The methodologies for determining special allowances are well defined and are not presently being disputed. Earnings management manipulation by bank

⁹ See Comptroller of the Currency (1996, p. 10) for specific references for the charge-off rules for credit card loans and consumer loans.

management in the Special Allowance category is difficult because this category entails a small number of very large loans with the valuation techniques well-defined by regulators (at least in the United States). In addition, because of their size, internal and external auditors as well as bank regulators often target these loans for review.

Credit Card Loans

Credit card loan portfolios have an extremely large number of very small loans. It has been the case in the U.S. that credit cards loans are charged as loss when they become past due 180 days. The rule should be applied automatically, without exception. Of course, collection effort can continue and the receipts from charged-off loans should be credited to the Allowance for Loan Losses as recoveries. The question of the ALL for credit card loans is moot as the Allowance exists only from the time the loan is past due 180 days until when it is charged off.

All Consumer Loans Except for Real Estate

These loans should be treated analogously to credit card loans. However, U.S. practice dictates that tolerance is usually less, for example, 120 days. The automatic charge-off rule is again applied.

The Determination of Loss Percentages in the No Allowance Category

This category represents loans and other financial instruments that are not in any of the other three categories. In order to use the statistical methods proposed in equation (4), it is necessary to capture all loans in this category in our loan database. For purposes of calculating the ALL, the borrower number (which aggregates related loans under one borrower), address, industry code,¹⁰ principal, accrued interest, payment history and risk classification would need to be captured.

The following risk classification system uses five risk classes. The number of risk classes is not standardized in the industry; however, this classification system corresponds to that used by the Comptroller of the Currency in its function of regulating and supervising national banks in the U.S. When a borrower has more than one loan, all of the loans are classified at the least creditworthy class indicated for any of the loans, following the accounting principle of conservatism. This practice can be in conflict with SFAC 2, which states, 'Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits' (FASB, 1980, para. 93).

A Markov chain theory transition matrix is now developed in a manner similar to that in Kim and Santomero (1993) to determine the probability of default in each classification.¹¹ The goal of the Markov chain approach, as used here, is to determine a steady-state probability of losses in each category as the best estimation possible for future losses. Like Kim and Santomero (1993), this article assumes a known

¹⁰ The S&P coding system of forty categories would be convenient; alternatively the SIC (Standard Industrial Code) may be used.

¹¹ An untested new modelling approach to this problem has been proposed by Lucas *et al.* (2001).

ABACUS

TABLE 2

DEFINITION OF LOAN RISK CLASSIFICATIONS

Risk classification	Description
PASS	Borrowers that are 'passed', that is, loans that are not classed negatively
Other loans especially mentioned (OLEM)	Borrowers showing the first signs of weakness from (a) operating losses, (b) change to unknown management or (c) highly leveraged borrowers
Substandard (SUBS)	These borrowers show material weakness from deficiency in balance sheet and/or operating losses. A reversal in trends is needed to reduce the possibility of loss
Doubtful (DOUB)	These borrowers show a significant probability of loan loss. Examples of reasons are: (a) continuing and escalating operating losses or (b) severe collateral deficiencies when collateral is viewed as an important source of repayment
LOSS	The loans to these borrowers can no longer be carried as an asset and are charged against the Allowance during the current reporting period

Source: Comptroller of the Currency Examination Procedures.

TABLE 3

MARKOV CHAIN THEORY TRANSITION MATRIX

	1. PASS	2. OLEM	3. SUBS	4. DOUB	5. LOSS
1. PASS	P_{11}	P_{12}	P_{13}	P_{14}	P_{15}
2. OLEM	P_{21}	P_{22}	P_{23}	P_{24}	P_{25}
3. SUBS	P_{31}	P_{32}	P_{33}	P_{34}	P_{35}
4. DOUB	P_{41}	P_{42}	P_{43}	P_{44}	P_{45}
5. LOSS	0	0	0	0	1

distribution (the loan classifications in Table 2 must be consistent) and statistical intertemporal independence. Given these assumptions, Kim and Santomero state:

the unique characteristics of the Markov process allows it to derive the probability of finding a loan in each state at a certain future period, given the initial state. In addition, the probability of each state in future periods, regardless of the initial state, *converges to a constant value, steady-state probability*. (p. 322, emphasis added)

Each P_{ij} represents the probability of i classification migrating to j over a given time period, usually one year.

For exposition, assume the following:

1. As Kim and Santomero (1993) did in their evaluation under a known distribution, losses are replaced by 'good' loans, classified here as 'PASS'. This condition is necessary since if losses (and payments) were not replaced, the total loans would diminish to zero over time.

2. Payoffs in each loan classification are replaced by a like dollar amount of loans in each classification.

Each P_{ij} is a historical mean based on the previous five years experience with the most current year being the experience for the twelve-month period ending in the calendar year end that is most current. These probabilities are calculated based on the performance of the individual loans. It is proposed that the P_{ij} s be calculated annually. The probabilities are calculated on the performance of the loans at the time of the calculation of the Allowance for Loan Losses.

The Markov chain theory, in essence, conveys the probabilities for a specific category of loan migrating to a specific state over a given number of cycles. This theory is used to develop the steady state probability, which is the probability to which each classification converges over time. In essence, this technique provides rigour to the migration technique used in the United States and the tracing method used in Japan.

In a manner analogous to the development of the steady-state values in Kim and Santomero (1993, p. 323), equations are developed for our steady state variables subject to the following condition:

$$P\hat{A}SS + O\hat{L}EM + S\hat{U}BS + D\hat{O}UB + L\hat{O}SS = TOTAL\ LOANS \quad (6)$$

The steady state condition becomes:

$$O\hat{L}EM = P_{12}P\hat{A}SS + P_{22}O\hat{L}EM + P_{32}S\hat{U}BS + P_{42}D\hat{O}UB \quad (7)$$

$$S\hat{U}BS = P_{13}P\hat{A}SS + P_{23}O\hat{L}EM + P_{33}S\hat{U}BS + P_{43}D\hat{O}UB \quad (8)$$

$$D\hat{O}UB = P_{14}P\hat{A}SS + P_{24}O\hat{L}EM + P_{34}S\hat{U}BS + P_{44}D\hat{O}UB \quad (9)$$

$$L\hat{O}SS = P_{15}P\hat{A}SS + P_{25}O\hat{L}EM + P_{35}S\hat{U}BS + P_{45}D\hat{O}UB \quad (10)$$

To solve the five equations simultaneously and give the results in percentages of total loans, total loans are set at 100 and the format $\mathbf{Ax} = d$ becomes:

$$\mathbf{A} = \begin{bmatrix} 1 & 1 & 1 & 1 & 1 \\ P_{12} & (P_{22} - 1) & P_{32} & P_{42} & 0 \\ P_{13} & P_{23} & (P_{33} - 1) & P_{43} & 0 \\ P_{14} & P_{24} & P_{34} & (P_{44} - 1) & 0 \\ P_{15} & P_{25} & P_{35} & P_{45} & -1 \end{bmatrix} \begin{bmatrix} P\hat{A}SS \\ O\hat{L}EM \\ S\hat{U}BS \\ D\hat{O}UB \\ L\hat{O}SS \end{bmatrix} = \begin{bmatrix} 100 \\ 0 \\ 0 \\ 0 \\ 0 \end{bmatrix} \quad (11)$$

and $x = \mathbf{A}^{-1}d$.

To give an example, consider a fictitious bank with the following transition matrix:

$$\mathbf{T} = \begin{bmatrix} .944 & .020 & .030 & .005 & .001 \\ .600 & .310 & .050 & .020 & .020 \\ .400 & .100 & .400 & .050 & .050 \\ .050 & .150 & .200 & .300 & .300 \\ .000 & .000 & .000 & .000 & 1.00 \end{bmatrix} \quad (12)$$

where

$$\mathbf{A} = \begin{bmatrix} 1 & 1 & 1 & 1 & 1 \\ .020 & -.690 & .100 & .150 & 0 \\ .030 & .050 & -.600 & .200 & 0 \\ .005 & .020 & .050 & -.700 & 0 \\ .001 & .020 & .050 & .300 & -1.00 \end{bmatrix} \quad (13)$$

and

$$\mathbf{A}^{-1} = \begin{bmatrix} 0.894 & 1.544 & 2.037 & 2.574 & 0.894 \\ 0.036 & -1.419 & -0.198 & -0.294 & 0.036 \\ 0.051 & -0.052 & -1.617 & -0.378 & 0.051 \\ 0.011 & -0.033 & -0.107 & -1.446 & 0.011 \\ 0.008 & -0.039 & -0.115 & -0.456 & -0.992 \end{bmatrix} \quad (14)$$

The inverse matrix was calculated using Microsoft® Excel. Therefore

$$x = \begin{bmatrix} 89.43 \\ 3.58 \\ 5.14 \\ 1.11 \\ 0.75 \end{bmatrix} \quad (15)$$

and the estimated losses from this portfolio by the Markov chain theory are 0.75 per cent of the total loans.

The following are the requirements for assuring consistent and reliable estimates of *LÖSS* with the Markov technique:

1. Maintenance of accurate historical records of probabilities (based on dollars rather than number of loans) to form the transition matrix.
2. A computerized system that maintains the current and historical risk classification of each loan.
3. A consistent loan classification scheme. It is interesting to note that the classifications need not exactly accord with the definitions given in Table 2, but they must be consistent. For example, if loans in a given year that should have been classified 'substandard' are instead classified 'doubtful' the calculations will still provide an unbiased estimate of loan losses provided that the same 'classification error' is used for all years represented in the transition matrix. Therefore consistency assures a convergence on a steady-state condition.

Off-Balance-Sheet Risk

Various off-balance-sheet activities, such as letters of credit of commercial banks, create a credit risk that must be carried in the *ALL* according to the Office of the Comptroller of the Currency (Comptroller of the Currency, 1996, p. 3). Examples of such activities are: loan commitments, standby letters of credit and letters of

credit; futures, forward contracts, swaps, and options; when issued securities; and loans sold (with recourse) (Saunders, 2000, pp. 270–4).¹² As an example, *credit* risk exists in a futures contract to the extent that there is a probability that one of the counter-parties to the contract will fail to perform under the contract if called to do so. Altman and Saunders (1997) pointed out that even this assertion is confounded by the fact that only those contracts where the counter-party is out-of-the-money can have any credit risk. Therefore the level of credit risk in off-balance-sheet activities is not a simple calculation of the magnitude of such transactions, but rather a series of calculations based on the creditworthiness of the parties to the transactions.

Since off-balance sheet transactions tend to be short term, where loans are both short term and long term, and the riskiness of a loan *ceteris paribus* increases with the term of the loan, off-balance-sheet credit risk transactions would not be riskier than loan credit risk granted to the same borrowers. Therefore again using the principle of conservatism, the risk of credit loss will not be understated, although it may be overstated, if the same transition matrix probabilities as those given in the Markov chain theory analysis are used. To use this method, the bank must assign a risk classification to each counter-party. Only counter-parties that are out-of-the-money are considered. By assigning these classifications it will be possible to develop historical information on the performance of off-balance-sheet risks and over time develop a separate transition matrix. In the interim the same transition matrix can be used as for loans, and the estimated probability of loss will therefore be the same as for loans.

Concentration Risk

The banking industry has long recognized that concentration of loans, both geographically and by industry, increases risk. The performance of the major oil-producing states in the United States (Alaska, Colorado, Louisiana, New Mexico, Oklahoma, Texas and Wyoming) provided an excellent example of this increased risk 'which occurred when oil prices dropped by about 50 per cent in the first half of 1986' (Chevalier and Scharfstein, 1996, p. 713). From 1987 through 1990, Alaska, Louisiana, Oklahoma and Texas represented 69.8 per cent of the total bank failures while they only represented 16.6 per cent of the total banks (various Federal Deposit Insurance Corporation reports). These figures are somewhat influenced by the number of multi-bank holding company banks in Texas; however, the numbers are sufficiently dramatic to demonstrate the point of concentration risk. Geographic concentration also contributed to risk, especially in Texas, due to the relatively small size of the banks.

Methods to decrease concentration risk include mergers, *de novo* expansion, increasing the percentage of participation loans bought relating to borrowers out of a bank's immediate market area and the solicitation of loans outside a bank's

¹² However, in the case of Wells Fargo Bank derivative financial instruments such as interest rate futures and forward contracts, interest rate floors and caps, options and interest rate swap agreements are provided for separately from the ALL—see Wells Fargo, 2001, p. 91.

normal market area. Prior to 1999, mergers across state lines (but not internationally) were limited by various state laws. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 partially eliminated these restrictions in 1995 and fully eliminated them in 1997 (Kane, 1996). Since that time the number of banks in the United States has decreased from 9,403 in 1997 to 8,043 in 2003 (FDIC, 2000; 2004), almost entirely through mergers. However, a measurement, or system of measurement, of this risk for a bank that would equate to a definite addition to the Allowance for Loan Losses has proven elusive. Until an unbiased, consistent measurement is developed, a bank, together with its primary regulator, must subjectively estimate the additional risk to the bank from concentration risk and add that total to the Allowance.

Economic Risk

FFIEC (2001, p. 35634) stated, 'Descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates and other loss measurements' are a factor in determining and measuring impairment under FAS 5. Ahmed *et al.* (1999, p. 9) used the 'change in business failures in a bank's market' as one of the proxies for the non-discretionary component of the Allowance.

The risk from a deteriorating local economy and a deteriorating national and/or international economy, like concentration risk, must be estimated by the management of the bank and inserted as a calculation for the total Allowance for Loan Losses. The definition of what is the 'local economy' and what is the 'national economy' would vary widely. For example, a small community bank in Iowa may define its local economy as an individual county and the national economy as that of the United States. Conversely, an international bank, such as Deutsche Bank, could define its local economy as Germany and its national economy as an aggregate of OECD countries. There is substantial room for differing definitions across the banking spectrum; however, the important considerations are that the definition for an individual bank be logical and comply with banking regulations applicable for the bank and be applied consistently over time. This particular variable is susceptible to manipulation which makes consistency of method over time the best safeguard.

CONCLUSION

This article demonstrates that two necessary conditions for significant earnings management to exist in the commercial banking industry are present: (a) an incentive exists for executives to use earnings management techniques, and (b) a large accrual account subject to considerable discretion in how its transactions are reported provides the means.

A methodology is offered which minimizes the potential for earnings management while allowing a commercial bank appropriate discretion in its entries into the Allowance to reflect such changes as significant macroeconomic events. The partially conflicting goals of bank regulators, the accounting standard setters and commercial bankers are considered in the development of this methodology.

CALCULATING BANKS' LOAN LOSS ALLOWANCE

All stakeholders would benefit from the adoption of the proposed methodology. In accord with recent (2003) Basel II directives, the application of the methodology would assist in satisfying the aim of comparability of reported bank data. By providing a specific, verifiable method for calculating the non-discretionary portion of the Allowance, the accounting regulators' concerns over transparencies would be assuaged. By maintaining a discretionary portion, which would be subject to examination by the bank regulators, both the bankers and their regulators' concerns over maintaining appropriate flexibility would be significantly lessened. International accounting regulators would have a basis for setting international standards which incorporates some of the best practices currently in use. Regulators and external auditors would benefit from having a methodology that can be consistently audited for the nondiscretionary portion of the Allowance and a more structured methodology for the discretionary portion. Finally, investors would gain confidence in the transparency and reliability of financial statements of commercial banks and bank holding companies.

This article provides an analytical framework for which further empirical research using actual empirical data is encouraged to seek evidence as to its feasibility. This research is necessarily limited to those having access to private and confidential bank data and could be undertaken by regulators or academics in consultation with cooperative banks.

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JOEL AMERNIC AND RUSSELL CRAIG

Reform of Accounting Education in the Post-Enron Era: Moving Accounting 'Out of the Shadows'

This article reflects critically on the general state of university-based accounting education. It highlights the chiding of business school educators by the President of the U.S.A., George W. Bush, in his response to the collapse of Enron and subsequent corporate failures. It draws attention to Bush's plea for corporate accounting to be moved 'out of the shadows'.

An agenda of reform for accounting education is proposed, seeking a greater responsiveness by accounting educators to three broad matters: first, the political, rhetorical and ideological nature of accounting; second, the 'poverty of discourse' in accounting curricula; and third, the merits of a better understanding of accounting history. It is suggested that responsiveness to these matters be manifest in a stronger commitment to critique of accounting. This entails implementation of four curriculum themes commencing in the first class in accounting. The benefits of reading and reflecting upon the collected life's work of distinguished intellectual forbears of our discipline are canvassed. Wide-ranging general proposals for the reform of accounting education are advanced.

Key words: Accounting; Bush, George W.; Curricula; Education, Enron, Reform.

— 'What Enron has done is recast the landscape'¹

In the wake of the collapse of Enron, WorldCom and other large companies during 2001 and 2002, there have been many proposals to reform accounting, auditing, and corporate governance. These have included strong calls from diverse quarters for the business community to commit determinedly to new ethical and moral values, to develop better mechanisms for corporate governance, and to exercise

¹ Professor Royston Greenwood, Center for Professional Service Firm Management, University of Alberta, in an interview with Lorinc (2002, p. 26).

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better corporate responsibility. For some, one of the causes of the seemingly never-ending parade of accounting scandals and unexpected company collapses has been the inadequacy of university curricula in accounting and business education (Bush, 2002; Sikka and Wilmott, 2002). Indeed, reform of accounting education has been regarded as of 'economic importance' by such influential voices as PriceWaterhouseCoopers (2003, p. 3): they have argued that 'accounting educators must play a clear role in restoring the public trust . . . [and that] we must consider what reforms are necessary in the accounting education system that in turn develops practitioners who provide critical support to the US economy'.

This article examines aspects of the alleged culpability of accounting educators for the accounting-related behaviours that contributed to major corporate crises in 2001 and 2002.² It explores whether there is substance to the explicit entreaties and implicit accusations levelled at accounting and accounting educators by American President George W. Bush in particular; and the political establishment, the financial press and other critics, in general.³ We explore the criticisms President Bush levelled at accounting and business school educators. But many of the issues he raised, directly and indirectly, are beyond the scope and capacities of a single scholarly article. Accordingly, three matters are stressed.

First is the need for accounting educators to have students appreciate the idiosyncratic, political, rhetorical, ideological and non-objective nature of accounting. It is important for accounting educators and the general populace to embrace a (for many, novel, but more realistic) view of accounting as something other than a tangible and technical means of accessing a 'measurable world'. The domain of

² The restricted focus of this article (on the culpability of accounting educators) should be appreciated from the outset. A reviewer has criticized its scope on three grounds. First, because we do not specifically address the culpability of accounting educators within a wider framework of culpability (e.g., one that would also encompass bankers, investments analysts and regulatory agencies); and second, for failing to address the issue of the role of the university in providing accounting education. We touch on these issues generally, but have deemed specific analysis of them beyond the scope of this article. Third, we are criticized for our 'U.S./Australian' (rather than 'U.K./European') orientation. We have not deliberately set out to 'privilege' one geographical domain over another. The orientation of the article is an inevitable outcome of the location of the lifetime university teaching experiences of the authors over (together) sixty-three years; the identity of the chief motivating protagonist for the article (George W. Bush); the fact that the unexpected corporate failures prompting the current soul-searching in accounting have predominantly been American; and the fact that the distinguished former accounting professors we have chosen to illustrate our argument are an American and an Australian. We do not regard this alleged bias to be distortive. But readers are invited to be mindful of this criticism as they proceed.

³ Never, it seems, has the allegedly arcane art practised by accountants been scrutinized so publicly. For example, an editorial in the largest circulation daily newspaper in Canada, the *Toronto Star*, dated 3 July 2002, lamented that there was a 'new revelation almost every day of crooked accounting practices'. There are indicators too that some accounting educators are cognizant of their possible complicity in facilitating such practices. For example, in his testimony before a subcommittee of the Committee on Financial Services of the U.S. House of Representatives, accounting professor Robert Verrecchia (2002) admitted that 'Many of the instructors at Wharton are sensitive to the concern that in regaling students with tales of financial reporting chicanery, we may also be promoting this behavior on the part of our graduates. In our conceit, we rationalize our way around this dilemma by arguing that in any accounting Armageddon, it is important for our students to be better armed than the students from our peer institutions'.

accounting ought not to be characterized axiomatically as precise, objective and capable of producing financial statements upon which anyone ought to be capable of attesting that they represent a 'true and fair' view (in any ordinary sense of the words). It is important to convey a sense of the 'abstract' about accounting. In particular, about how accounting is a fashioner of perception and image, and how it unavoidably embraces rhetoric, metaphor and ideology.

Second, we explore and review what is taught in accounting—the curricula.⁴ Views of the late Professor Raymond J. Chambers (1994, 1999) are cited to argue that important fundamentals are routinely ignored in our teaching and research and that, consequently, there is a 'poverty of discourse' (Chambers, 1999) in accounting education.

Third, history is drawn upon to provide some counterbalance to the hyperbole, overblown emotion and jaundice in the current debate. Several long-standing criticisms of accounting and accounting education that seem to have had no lasting effect are cited. In so doing, current critics and commentators (including President Bush) are reminded that recent indictments of accounting, and some of the reforms suggested, are *déjà vu*, and have been ignored by accountants and accounting educators for decades. We cite some examples of these criticisms and invoke them as part of an appeal for greater regard to be accorded to the study of accounting history.⁵ Accusations of failing to heed the lessons of our history will have more substance if ignorance of accounting's past can be shown.

To illustrate that the current criticism and scorn for accounting and accountants (and by implication, accounting academics) is not a new phenomenon, support is drawn from two rich and pertinent sources: the writings and commentary of Professor Henry Rand Hatfield (1866–1945), the 'humanist, scholar and accounting educator' (Zeff, 2000, p. iii); and Professor Raymond J. Chambers (1917–99), 'an eminent scholar, influential theorist, prominent educator, dedicated researcher, and important contributor to the study of the history of accounting thought' (Al-Hogail and Previts, 2001, p. 24). We infuse the latter sections of this article with their thoughts and utterances. There are a dozen or so distinguished scholars in accounting we could easily have chosen to illustrate our case. But we have settled on Hatfield and Chambers because we wanted to draw upon the evidence of their diverse backgrounds, generations and principal reasons for distinction. Whereas the American, Hatfield, was prominent in the first half of the twentieth century, the Australian, Chambers, was prominent in the second half. Whereas Chambers was better known for his 'grand theory' of *Continuously Contemporary*

⁴ We use the terms 'curriculum' and 'curricula' to emphasize what is taught in accounting. Of course, the way accounting is taught is crucial too. For example, Amernic and Enns (1979) consider the role of structure in the accounting curriculum, and Bebbington and Thomson (2002, abstract) argue that 'how one teaches is equally important as considering what you teach'.

⁵ The plea to study accounting history opens the door to many other issues, of course, including *whose* notion of history. But the very idea of framing accounting curriculum from a historical perspective seems salutary, and thus we agree with admonitions such as that by Ijiri, who urged 'all accounting academicians and practitioners' to 'gain the super-long-term perspective that history offers, from which to view contemporary events' (2002, p. 166).

Accounting (CoCoA), Hatfield was not regarded as a grand theorist. He was better known as the 'dean of accounting teachers' for his oral and written pedagogy and as a 'significant contributor' to the 'early evolution of accounting as an academic and professional field' (Zeff, 2000, p. xv).

We reflect also upon the implications of Enron for accounting education and conclude by advancing a tentative reform agenda aimed at enhancing the quality of accounting curricula.

BUSH'S FINGER OF BLAME

Accounting has rarely received such a high level of sustained attention by the media and the general populace as it has since the onset of the *Enron* affair, and similar corporate scandals, in late 2001. Numerous editorials and feature articles in prominent newspapers and news magazines, biting editorial cartoons, a steady diet of commentary on current affairs television, and Congressional hearings before various committees of America's House of Representatives and Senate, as well as reverberations outside the U.S.A., all attest to the recent cultural prominence (earnestly unwanted by the profession) of *accounting*. But perhaps one of the most significant of all these social and media indicators has been the attention that President George W. Bush has paid to accounting.

On 9 July 2002, President Bush delivered a much-heralded speech in New York on 'Corporate Responsibility' (reproduced in the Appendix) in which considerable focus was given to the *mis*-performance of corporate accounting. The speech received mixed reviews in the business media (Crane, 2002; Dobbs, 2002; Olive, 2002), but was promoted widely as a government manifesto on corporate reform. President Bush used the speech to announce tough corporate accountability enforcement initiatives following the accounting and related scandals of Enron, Global Crossing, WorldCom, and numerous other companies. Bush (and his advisers and speech-writers) clearly seemed to be of the view that the inadequacy of university curricula in accounting and business education was, in good part, responsible for the spate of accounting scandals and corporate collapses in the U.S.A. in 2001 and 2002.

The fact that such a prominent, powerful political figure as the President should engage in criticism of accounting and business educators should not be surprising. As Osborne (2003, p. 22) has observed, we should acknowledge that the nature of the *realpolitik* in an era of mass higher education (much of it funded by government) is that universities increasingly have to accept the responsibilities and expectations imposed by society and government. Consequently, universities should not expect to operate as idiosyncratic 'ivory towers' at the periphery of society where they are afforded a safe haven from which to pursue their own curricula unobtrusively and without 'the glare of public scrutiny' (Osborne, 2003, p. 22).

Morally Confused 'Surrenderers'

President Bush used powerful rhetoric as part of his *j'accuse*. He did so *explicitly* through his entreaty that 'Our schools of business must be principled teachers of

right and wrong, and not surrender to moral confusion and relativism' (see Appendix). What George Bush meant by this is perplexing. His argument seems to be based on what philosophers refer to as 'relativism in morality'—a relativist view in which 'each person, or interest group, has its own views as to what is right and wrong, and acknowledges there is no absolute standard that can validly decide between them' (Campbell, pers. comm., 2002). Yet, curiously, Bush seems to imply there *is* an absolute standard by which to choose between 'right' and 'wrong'—presumably, *his* standard. Bush's recourse to 'relativism in morality' is self-refuting and incoherent because he adopts a relativist stance himself—albeit one in which a person simply 'adopt[s] the *policy* of not admitting to serious consideration claims which others present as contrary to [his/her] own unless those claims seem true to [him/her]' (Campbell, 1992, p. 402).

There seems to be no room in President Bush's argument for tolerance of ambiguity, diversity, deviance from accepted norms (all values of 'traditional' universities), as these would constitute 'unprincipled' behaviour. So, in a sense, the university ideal of exposure to a variety ('a universe') of views of the business world, of tolerating non-conformist behaviour by denizens of that world, and of countenancing the teaching of material that is unorthodox, unconventional and anti-establishment is anathema. Bush seems to have a vision of a non-pluralist, conformist world of business education in which there are rigid rules-based curricula, free of corporate critique, and sustained by strictly regimented servings of conservative, 'moral majority' and neo-conservative-accepted views. If so, then Bush is misguided. Business education seems to be regarded as 'principled' if it adheres to his 'world-view' of right and wrong. Those educators who don't adhere to Bush's views, but act in accordance with their own principles and the ideals of a university, are wrongly condemned as morally confused, and unprincipled, 'surrendering' reprobates. Of course, in highlighting the inadequacies of Bush's stance, it is acknowledged that we might attract deserved criticism for engaging in the type of 'moral relativism' for which we scold Bush. Therein lies an important point: One should be less dogmatic and more cautious about moral values, including about 'right' and 'wrong'.

Three Implicit Failures of Accounting Educators

A much stronger *implicit* rebuke for accounting educators permeates President Bush's statement. Bush invokes a powerful metaphor to indicate his administration's intention to 'mov[e] corporate accounting out of the shadows, so the investing public will have a true and fair and timely picture of assets and liabilities and income of publicly traded companies' (Appendix). Bush's 'shadows' metaphor includes strong evocative imagery and entailments. It conjures an image of accounting as something that is dark, lurking and sinister—as something that needs to be more open, savoury and subject to scrupled illumination. Indeed, his deployment of this metaphor is resonant with a more pervasive metaphor in American social life—U.S. Supreme Court Justice Brandeis' much-quoted dictum, 'Sunlight is the best disinfectant'. Brandeis' metaphor and its derivatives are evoked often in connection with legal matters and corporate and securities issues, and Bush has adroitly tapped into that reservoir of metaphorical capital.

In advocating a 'move . . . out of the shadows', Bush, in effect, signalled at least three performance failures by accounting educators.

Failure to Deliver Professional and Moral Behaviour Implicit in Bush's rhetoric is the view that accounting and business educators have failed to properly fashion the bright impressionable minds of young students entering the accounting profession. Under this view, accounting educators have neglected to make students aware of their obligations as professional persons: to have them accept, as reflexive compunction, the need to act in an honest way, with integrity, and to commit to a life in which they forsake personal well-being for the interests of the broader community. We are invited to believe that the result of this alleged neglect is a dilution of the professional status and moral foundations of accountants. The sentiment associated with this viewpoint was lampooned in a cartoon by Dolighan (2002) in which a student bedecked in graduation robes and with degree testamur in hand is berated by his despairing, incredulous parents: 'You want to be an ACCOUNTANT!? Where did we go wrong? We tried to give you a good moral foundation.'

However, such sentiment misses an important point. Whereas accounting educators (and the parents in Dolighan's cartoon for that matter) can teach students *principles* of ethical and moral behaviour, they cannot (and should not) be held responsible for the *actual* ethical and moral behaviour of students after graduation.

Despite the best intentions of determined curriculum reform initiatives over many years (e.g., Bedford Committee Report of the American Accounting Association [AAA], 1986; Albrecht and Sack, 2000), accounting educators seem to be regarded as having abrogated their duty to provide well-rounded graduates of service to society. There are some meritorious aspects of this 'abrogation hypothesis'—but not necessarily those Bush had in mind. For example, there are strong grounds for contending that accounting educators have been compliant facilitators of the 'technicization' of auditing and accounting (especially but not exclusively in the U.S.A.), of the marginalization of the genuinely independent, adversarial, arm's-length audit (see Briloff, 1990). Further, they have done so in the absence of *critique* (a matter to which we turn shortly).

If the way contemporary accounting is practised is 'in the shadows' and validly characterized (using terms employed by Bush elsewhere in his speech) as misleading, 'false', deceptive, 'dishonest', unethical, untrustworthy, lacking transparency, corrupt, 'shading the truth' and 'cooking the books', then isn't that the fault, in good part, of accounting educators? Clearly, many social commentators, such as cartoonists, seem to think so. For example, a cartoon in Canada's *Windsor Star* (3 September 2002) shows two university undergraduates conversing. The caption has one saying to the other: 'I'll be studying cooking and bookkeeping . . . I plan to be a corporate accountant.'

But accounting educators should not be held directly responsible: the central problem is, in large part, ingrained and systemic. Even if auditors were educated to be ethical and moral (assuming that we could agree on the meaning of these terms) and, in their professional lives as auditors, were 'as honest as possible,

[had] impeccable integrity and [were] competent and intrepid to the hilt', the fact that they follow and endorse generally accepted accounting rules and practices means that 'almost certainly they will be signing off on what mostly is financial nonsense!' (Dean *et al.*, 2002, p. iii). All the 'moral foundation' in the world will not help an auditor who acts honestly, but attests in good faith to depictions of wealth and profit that have resulted from the deployment of a collection of generally accepted, but highly dubious, accounting practices involving such things as provisioning for bad debts, capitalizing expenses, writing off assets, or recognizing sales revenue in advance of product delivery. Auditors who intend to pursue a moral path, to do the right thing (however unlikely it is that a society can agree on just what this is, other than by compulsion), are bound to failure, except in the most trivial way, if (as Dean *et al.*, 2002, claim) the foundation of the reporting system upon which they attest to compliance is, itself, a perversion.

The Absence of Critique A second failing of accounting educators, implicit in President Bush's rhetoric, is to allow accounting to continue to be perceived by the public as somehow a revealer of an underlying natural truth. Accounting academics are doubly at fault here because they are (or should be) the conscience of the profession,⁶ and not merely the willing servants of professional reproduction and corporate triumphalism. Their role in society is to make the teaching, research and practice in the discipline of accounting as good as it can be for society at large.⁷ One aspect of the role of accounting educators (which, from the tone of his speech, would probably sit uncomfortably with Bush) is to assess critically accounting practices and principles, and in doing so expose false prophets and humbug, including the political and economic ideologies that extant accounting practices and principles facilitate.

There are strong grounds for regarding accounting, the well-named *language* of business, as helping to make various customs and rituals (including some that are anti-human and anti-humane⁸) seem natural. We should remain alert to any contention that accounting is an important part of the 'production of images and discourses' in our society and is one of those crucial social practices 'that has to be analyzed as part and parcel of the reproduction and transformation of any symbolic order [because] [a]esthetic and cultural practices matter, and the conditions of their production deserve the closest attention' (Harvey, 1990, p. 355).

The Failure of Scholarly Endeavour? It is sobering to reflect on what has been (or ought to have been) one of the central purposes of accounting research and

⁶ This was clearly the view of the Cohen Commission (AICPA, 1978, p. 86): 'One of the roles of the academic arm of the profession is to serve as the conscience of the profession'.

⁷ Identifying and determining the interests of society at large is worthy of debate. We do not enter into that matter here.

⁸ For example, the cost-driven, profit-seeking rapaciousness of sweatshop factory labour practices adopted by some multinational companies in Third World countries.

teaching by thousands of accounting academics in many countries over many decades: theorizing and making socially serviceable the periodic measurement and reporting of the financial position (wealth) and operating performance (change in wealth) of a business entity. If, as President Bush argues, Enron and related scandals show that we still do not have reliable audited measures of assets and liabilities (wealth) and operating performance (profit), then there appear to be sustainable grounds for implying that this is a third failure by accounting educators. Despite much research that has allegedly made the practice of accounting better, nonetheless, decades of research and scholarly enquiry by legions of accounting academics might be characterized, generally, to have been in vain.

This may be a harsh assessment. Perhaps the problem has been that of ineffective transmission of knowledge⁹ from the halls of academe to the accounting and financial reporting systems of businesses. This is not surprising in view of the 'ten year retrospective of accounting education, 1992–2001' by Wilson (2002, p. 308) in which he highlighted, as a 'conspicuous' cause for concern, 'the limited dialogue which has emerged between accounting educators, accounting practitioners and staff in professional accounting bodies'. Many accounting academics seem to lack the communication skills and the rhetorical wherewithal to convince practitioners of the merits of their research and of the accounting 'theory' they espouse. Or perhaps the problem lies with the practitioner arm of the accounting profession and the semblance of antagonism and diffidence it often appears to display to academicians. The problem is not alleviated by what Goch observed in 1970 (and which we contend is still true today) as the 'tedious prose' of accounting academics. Goch (1970, p. 56) was flabbergasted about the incomprehensibility of accounting academics in communicating with practising accountants:

I cannot for the life of me understand why it is that when a man takes up a lecturing career he feels impelled to adopt all the trappings of the new accounting gobbledegook . . . Unless they want to be condemned forever to taking in each other's verbal washing, they have got to learn to communicate their ideas to their real audience—the broad mass of accountants—in good, plain, English.

Mautz (1974, p. 356) too, in lambasting what was at the time thought by many to be the world's most prestigious peer-reviewed journal in accounting, *The Accounting Review*, mused quizzically:

For goodness sake, what has happened to *The Accounting Review*? Most of us, and here I include academic types as well as practitioners, find this foreign language magazine almost impossible to read . . . I cite this as an illustration of how far apart academic and applied accounting have become.

What Mautz wrote in 1974 seems true thirty years later. Journals like *The Accounting Review* seem sadly out of step with the needs of society. They focus

⁹ Whether 'knowledge' is an unambiguously objective thing merits consideration. Gibbons *et al.* (1994) highlight the nature of 'knowledge' in its different 'modes' and also provide a useful overview of the uneasy relationship between academe and practice.

largely on superficial problems in order to demonstrate some versions of technical research virtuosity, avoid substantive critique, and adopt an almost hubristic gatekeeper mentality as an effective means of limiting perspectives.¹⁰ As Neu aptly puts it: 'Although accounting research is a thriving industry, the majority of accounting research remains insular from events of importance to the majority of the world' (2001, p. 321).

UNDERSTANDING THE POLITICAL, IDEOLOGICAL, NON-OBJECTIVE NATURE OF ACCOUNTING

In 2001, Professor Henry Giroux lamented:

As freedom is defined increasingly through the logic of consumerism, the dynamics of self-interest, an e-commerce investment culture, and all things private, there seems to be a growing disinterest on the part of the general population in such non commercial values as empathy, compassion, loyalty, caring, trust, and solidarity that bridge the private and the public and give substance to the meaning of citizenship, democracy, and public life. (2001, p. 2)

Giroux's lament should be of more than passing interest for accounting educators because all education, including that of accounting in the university, is political, and indeed, ideological. At the very least, students deserve to understand, critically, the discourses that render them, and their world, as they are. Should university educators promote accounting education as merely the learning of methods to facilitate 'better' private decisions? Should accounting educators be content, for example, to teach the technical mechanics of International Financial Reporting Standards despite concerns that these (and similar) accounting rules and requirements may have been developed in a social lacuna bereft of compassion for humanity? Should the possibility that the accounting we teach will help our students to design a 'better' management control system for a rapacious, profit-hungry mega-corporation be a source of contentment? How should the accountability of university accounting educators be discharged?

Giroux (2001, p. 2) appositely captures the point that accounting is not taught in the university (or in colleges, high schools, and elsewhere) with an intent to 'foster critical consciousness, engender a respect for public goods, and affirm the need to energize democratic public life and reinvigorate the imperatives of social citizenship'. Even in 'advanced', mature settings, financial accounting, for example, is taught as an information system that generates earnings numbers for business valuation models and, more generally, for 'contracting' purposes. Management accounting is taught as a decision-support system.¹¹ While there are instances of curricula that bring a more social (but hardly ever a radical)

¹⁰ As accounting academics, we acknowledge that we have been participants in such behaviour as well.

¹¹ Accounting curricula should not avoid such topics. Rather, they should be presented as 'technics' of ideological choice.

perspective, examples are rare¹²: they are often hived off in special, often marginal, courses. And when a more social, critical approach is proposed it is often in disguise.¹³

By ignoring the social perspective of accounting we are not playing 'fair' with the students who 'learn' accounting, and with the future generations of people who will bear the consequences of ill-informed accounting behaviour by those students when they enter practice. We should be mindful that accounting is not only a 'malleable resource' (Burchell *et al.*, 1980), but that it helps create a portrait of what many regard to be 'economic reality' (Hines, 1988). If nothing else, Enron provided vivid evidence of this. It is folly to argue that the failures of Enron, WorldCom and their like occurred because of a few rogue accountants and corporate executives who didn't receive sufficient dollops of 'ethics' as undergraduates or MBAs; and/or because U.S. GAAP was too 'rule-bound'. Rather, we submit that a principal cause is that accounting is taught by studiously avoiding its essence, or its kernel.

To address the issues raised above, we recommend the following four (related) curriculum themes be introduced and sustained from the very first lecture in accounting.

Language

Accounting should be acknowledged, earnestly, as a language, a way of seeing, a way of perceiving—and therefore as something that will be contested. By enrolling to learn a certain 'language', one acquiesces to ways of seeing and thinking about the world. Every time an instructor prepares an income statement for ABC Company in the first class of the first accounting course, a range of socially contestable pedagogical decisions have already been made. But the students (and probably the instructors, too) proceed as if blithely unaware of them. For example, when an accounting instructor shows that the accounting language of business constructs a company's income statement by defining the return to capital as a distribution and not an expense, then students should be invited to ponder the possibility that this reflects a privileging of capital over labour. In the case of Enron, the accounting language of business led to the construction of a company balance sheet which excluded certain special-purpose entities that met a technical test for exclusion. This was a very cynical and seemingly mindless following of the

¹² There are some prominent exceptions, such as at the University of Waikato, New Zealand. Several Scottish universities, such as the University of Aberdeen and the University of Strathclyde, also encourage a critical framework and allow it to permeate the curriculum. An undergraduate accounting text co-authored by two Scottish professors and used in Scottish universities (Bebbington *et al.*, 2001) adopts an encouraging approach: it starts by exploring accounting's role in society—including its role in major social struggles. It also takes the reader through the social constructionist arguments of Hines (1988), thereby attempting, at a first-year undergraduate level, to deconstruct some of the *totalizing* discourse about the purpose of accounting.

¹³ Grey (2002, p. 509), who questions the purpose of management education in business schools, suggests a way forward by concluding that 'from a review of published attempts at critical pedagogy, I suggested an approach that gives primacy to students' experience rather than to up-front theory or moralizing'.

'black letter' language of accounting rules and requirements, with little regard for the intent of those rules and requirements. When assets and liabilities in a company's balance sheet (represented in dollars of differing amounts of purchasing power) are added to obtain grand totals and are offset to determine 'net wealth', then an illogicality of adding together unlike units has been adopted, thereby reinforcing logical ignorance and mathematical impropriety. Together, these practices and others sustain an ideology of unthinking respect for authority which contributes systematically to a sort of mindlessness (Langer and Moldoveanu, 2000).

Accounting language seems far from a language of enlightenment and fair play. West (1994, p. 44), for example, drew attention to the potentially 'unenlightening' nature of accounting when he observed aptly 'one of the great ironies of contemporary accounting practice is the extraordinary imprecision of the words which define the fundamentals of accounting'. In this he has many supporters. Chambers (1994, p. 4), for example, drawing upon Montgomery (1937), implored us to 'fight for honest accounting, clear financial statements... [and] easily understood accounting' and to 'fight' against 'weasel words' in accounting.

Indeed, ironically, strong arguments can be made that accounting language does not 'resonate' with 'fair play'. Accounting seems more akin to a language of perversity, dogmatism, class privilege, and of a secret society inhabited by a cognoscenti who are the only ones able to cut through the technical jargon employed. For example, on the issue of perversity and class privilege, we must acknowledge that the language used in support of accounting practice is based on a world of corporate endeavour which assumes the primacy of shareholders, and which imposes legal and fiduciary obligations on directors and corporate officers to promote shareholder value—there is no equal fiduciary duty to promote the well-being of employees and communities. Kelly (2003) suggests an interesting thought experiment that forces us to consider an alternative world without such 'class privileging'—one in which employees and stockholders change places: where labour rights are primary and explicit, and where employees are spoken of as THE corporation, make up the boards of directors, nominate new members on such boards and have a fiduciary responsibility to maximize.¹⁴

The sociologist, Delaney, concludes (aptly in our view) that 'if we continue to treat financial figures as objective reflections of firm health... we will miss the crucial role that power and strategy play in creating the financial portrait of the

¹⁴ We are indebted to Sue Ravenscroft for this point. In her address to the Annual Conference of the British Accounting Association Special Interest Group on Accounting Education in Bournemouth (2003) she drew attention to the features of such a world. It would be one in which the financial press publishes wage and benefits data on a daily basis (an increase would be seen as a good sign; a decrease would signal a national economic downturn); share prices would not be publicly disclosed because individual shareholders would bargain for a price without knowledge of what other shareholders were paying for their shares. Shareholders would accept the terms offered to them, as other corporations are offering more or less identical terms—and if shareholders found some of these terms and conditions restrictive, and not to their liking, they could lose the right to any payments if they organized into shareholder unions. Shareholders would sometimes get no dividends and sometimes go for years without increases in dividends. This would be seen as a very good thing for a company, because wages would then go up more.

firm' (1994, p. 514). His metaphor of 'creating the financial portrait of the firm' helps position accounting language as a far-from-neutral representation of some (alleged) objective reality.

Our students deserve to be made aware of how accounting language serves as a means of perception, thought and (ultimately) action. Accounting curricula should take seriously the characterization of accounting as the 'language of business' and invite students to consider the social, rhetorical and ideological essences of language in general, and of accounting language in particular.

Embeddedness

Accounting should be acknowledged as embedded in the other so-called 'functional areas' of business¹⁵ and the world at large. Accounting, as language, has extended its ideological reach into these areas; it is a profound social mechanism. Like writing, accounting 'endow[s] social systems with an evolutionary dynamic' (Baecker, 1992, p. 157). The data upon which economics, finance, marketing, industrial relations, HRM, and corporate governance, among others, largely feed, begin often with accounting, because it 'deals with a microcosm of the world' (Ijiri, 2002, p. 166). Costs, cash flows, assets, liabilities, profits, return on investment, and gross margins, both past and future, are found in all these functional areas of business. Indeed, areas like HRM pride themselves on becoming (allegedly) more objective by adopting quantitative accounting metrics such as return on investment to evaluate (in the case of HRM) various proposed training programs. Value-chain analysis and contribution margin calculations are integral parts of marketing. In industrial relations, financial statements are employed in collective bargaining to help assess a company's financial capacity to pay a wage demand. Consequently, Hines' (1988) contention that people see companies within accounting seems valid. Indeed, many business phenomena seem to not exist until *named* or *defined* by accounting: the issue of executive stock options as an expense is a case in point.

Complexity

The settings within which accounting operates should be acknowledged as complex and messy. The temptation to suppress complexity in the accounting curriculum must be avoided; we should not dwell on oversimplified models and invite students to believe they represent the real world. We should be prepared to introduce complexity early, and often. In doing so, one suitable strategy would be to start with the real world that students know and understand, and then build on that foundation.¹⁶ We must be alert to the desirability of not prescribing oversimplified

¹⁵ In 2003, the Association to Advance Collegiate Schools of Business (AACSB) listed the following 'traditional business subjects' for the purpose of determining inclusion in AACSB accreditation: 'Accounting, Business Law, Decision Sciences, Finance . . . Human Resources, Management, Management Information Systems, Management Science, Marketing, Operations Management, Organizational Behaviour, Organizational Development, Strategic Management, Supply Chain Management . . . and Technology Management' (2003, p. 6).

¹⁶ We are indebted to a reviewer for drawing our attention to this point.

EXHIBIT 1

ENRON AND A DRAFT ACCOUNTING CURRICULUM

Students arrive at the first class of a financial accounting course, having taken a course in introductory financial accounting. Towards the end of the first class, after the instructor has introduced the theme of 'quality of earnings' (Amernic and Robb, 2003), a discussion case is distributed which consists of a set of financial statements of a company identified as 'GES Corporation', along with the following instructions:

Assume that you are the 'accounting and financial information advisor' to the chief negotiator for your union, the Amalgamated Union of Canada ('the AUC'). It is early in 2003, and the AUC is preparing for the upcoming negotiations with the company that employs their members, GES Corporation ('GES'). GES is involved in several types of businesses, especially the buying and selling of various forms of energy. Your main job is to ensure that the union negotiating team is prepared to make supported arguments concerning GES' ability to pay a compensation increase. The most recent set of financial statements of the company follows below.^a

1. Derive financial statement ratios that might be helpful to you in your role. Be prepared to explain why the ratios that you have derived are helpful.
2. Is GES profitable? Explain.
3. Are any problem areas apparent in the financial information? Explain.
4. Do you have any comments on the company's cash flows? What would be the 'optimal' cash flow pattern (that is, if each of CFO, CFI, and CFF can take on either positive or negative values representing cash inflow or cash outflow, respectively, what pattern of signs is 'best', and why?)
5. Based on the information provided and your analysis, does GES have the ability to pay the members of the union a compensation increase? Explain.

The results of the analysis indicate a company that is, according to the financial accounting information given, profitable, with increasing revenues, and with its most recent three years showing an optimal cash flow pattern of positive cash flow from operations, negative investing cash flow, and positive financing cash flow. Almost unanimously, students claim that—in answer to question 5 above—GES has the ability to pay a generous compensation increase. But then comes the zinger: the instructor announces that GES is in reality a well-known public company . . . Enron, with the financial statements being its final year (2000) along with comparatives. An audible gasp usually is heard from the majority of students.

This 'set-up' in the first week is a prelude to a major assignment in which students are required to read and interpret the detailed testimony before the U.S. senate's Subcommittee on Investigations by Robert Roach, the subcommittee chief investigator, on Enron's so-called 'prepay' transactions with Chase, Citibank and other apparently complicit financial institutions. The testimony is available at <http://govt-aff.senate.gov/072302roachindex.htm>.

^a The financial statements are not reproduced in this article.

textbooks—or be mindful of the need to use them with caution. We should not ignore the teaching potential of a variety of accounting curriculum strategies, such as the planned withdrawal of structure (Amernic and Enns, 1979).

Students should be encouraged to read, and reflect upon, *real*, not textbook, accountings. This is not simply a plea for 'more cases' in accounting education. In our experience, many cases are trivializations of the complex, ideologically laden

world in which people lead their lives. Many cases typically deployed within the accounting curriculum carry significant hidden ideological baggage.¹⁷

One way that we have experimented with complexity, while at the same time striving to incorporate Enron into our curriculum in a way that it is perceived to be part of the ongoing need to monitor the (unavoidable) excesses of capitalism, is described briefly in Exhibit 1.

Metaphor

We need to identify the metaphors that inhabit the conceptual frameworks of financial accounting,¹⁸ and the various authoritative standards encompassing GAAP. We need to be sensitive to the metaphors that slip, perhaps unnoticed, into managers' thinking, talking and acting about the accountings of their businesses.¹⁹ An appreciation of these metaphors is important, for they inevitably influence management's business and accounting decisions (Lakoff and Johnson, 1999; Amernic and Craig, 2000a, 2000b; Craig *et al.*, 2001).

It seems fundamental and legitimate to examine the strong ideological footprint that metaphor leaves behind. Many of our pedagogical, heuristic and constitutive metaphors (Klamer and Leonard, 1994) in accounting and business education are subtle but often need to be acknowledged as dangerous, seductive and misleading. Metaphorical framing in accounting and business education often precludes a more realistic consideration of accounting curriculum issues. For example, the naming of the 'sunk cost fallacy' contributes to hasty conclusions regarding so-called sunk costs. In this vein, Walton (2002, p. 473) contends that 'the sunk costs argument is not always fallacious, and in many cases can be seen to be a rational pre-commitment strategy'.

Postman calls metaphor an 'organ of perception' (1996, p. 174), a view consistent with taking the characterization of accounting as the language of business seriously. Metaphor needs to be brought into accounting education both in a macro and a micro perspective, for each of these perspectives contributes to the ideological construction of the language of business. In macro-perspective, for example, the very naming of accounting's conceptual framework evokes, metaphorically, a coherent structure. Like a framework of a building, it provides a logic of relationships that collaborate in the creation of a totality. It stands with its parts working together in a sort of natural unity, following (perhaps) natural laws in much the same way that a physical framework must follow natural, physical

¹⁷ One way to 'see' this would be to critically analyse an exemplary accounting case—one that has been lauded widely and republished for decades, even up to the present day: Birch Paper Company (Manes, 1970; Burns, 1968; Anthony and Govindarajan, 1995; Simons, 2000). One might use the critical approaches of a 'mild deconstruction', for example (Craig *et al.*, 2001), to bring to the surface what is ignored in the commonplace technical approaches to this accounting chestnut—or in virtually any other case for that matter.

¹⁸ The notion of an accounting 'framework' for concepts is an uncontested metaphor, discussed below.

¹⁹ For example, recourse to the pervasive accounting metaphor 'the bottom line' effectively shuts off interchange.

laws in order for the building to be durable, reliable, functional and predictable in its use. By (perhaps unobtrusive) metaphorical mapping from the domain of physical structures and their frameworks to the domain of accounting, the entailments thus transported may serve subtle, but profound, ideological ends in accounting and business. Indeed, in an even larger sense, the way we think, metaphorically, about accounting as a discipline has strong potential to frame the questions that we think are important for both our teaching and research. Is accounting metaphorically information in Demski's sense of 'a commodity whose acquisition, like that of other commodities, constitutes a problem of economic choice' (Demski, 1980, p. 2)? Or is accounting metaphorically text that is susceptible to varieties of textual analysis (Macintosh and Baker, 2002)? Or is it metaphorically a historical record (albeit another sort of text), or metaphorically something else, or metaphorically all these things at various times?

In micro-perspective, the accounting definitions that have been accorded revered status by standard-setters have an (unavoidably) metaphorical character that needs scrutiny in curriculum. For example, a common definition of the term *asset* in authoritative accounting literature is:

Assets are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. (CICA Handbook, Section 1000, 'Financial Statement Concepts', para. 29)

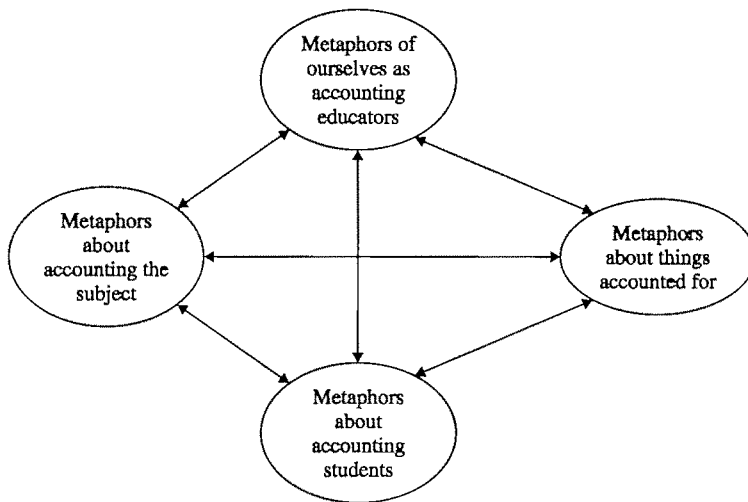
Many metaphors inhabit this definition. For example, we have:

- assets are 'economic resources',
- entities are controllers,
- assets are sources of 'future economic benefits',
- entities engage in 'transactions',
- entities are affected by 'events',
- entities are capable of extracting 'future economic benefits', and
- entities move through time.

Acknowledging metaphors (and cultivating the creative expression of identifying them) is important since people often (perhaps subliminally) reason and argue from definition (McGee, 1999), thus making their arguments to others (and also to themselves) based at least partly from the definition's metaphors. Making plain the metaphors and their entailments seems likely to broaden and deepen the usefulness and benefits of our accounting curriculum. Neil Postman highlights the importance of exposing our students to the metaphors in a discipline:

Through metaphors, we see the world as one thing or another . . . [i]s history unfolding according to some instructions of nature or a divine plan? Are our genes like information codes? . . . Do I exaggerate in saying that a student cannot understand what a subject is about without some understanding of the metaphors that are its foundation? I don't think so. In fact, it has always astonished me that those that write about the subject of education do not pay sufficient attention to the role of metaphor in giving form to the subject. In failing to do so, they deprive those studying the subject of the opportunity to confront its basic assumptions. Is the human mind, for example, like a dark cavern (needing illumination)? A muscle (needing exercise)? A vessel (needing filling)? (1996, p. 174)

FIGURE 1



Thus, metaphors we have about accounting the subject, about the things accounted for, and about accounting students (and, of course, about ourselves as accounting educators also) deserve reflection as we confront curriculum and other teaching choices. As shown in Figure 1, these metaphorical complexes seem to work together to frame the way we, as accounting educators, engage accounting education.

A reviewer has drawn our attention to the importance of reflecting upon the ways in which metaphors imperceptibly fashion the attitudes of educators too—including those of the authors in this article. From Fox (1983) and Lucas (2002), one can identify the metaphors that lecturers use when talking about teaching, and posit four conceptions of teaching:

- the 'transfer' conception: knowledge is a commodity to be transferred from one vessel to another;
- the 'shaping' conception: teaching is usually directed to 'developing' the minds of students;
- the 'travelling' conception: the teacher 'leads' students into new territory and, in doing so, gains new perspectives too; and
- the 'growing' conception: the teacher is a 'nurturer'.

The metaphors we deploy do not give equal weight to each of these conceptions and some reader caution might be advisable. We emphasize the 'subject matter as food' and 'learning as digestion' metaphors to give primacy to the transfer conception of teaching. Additionally, we promote the shaping conception by placing responsibility for learning on the teacher rather than the student. But, as a reviewer has rightly noted, such an approach has some deficiencies: 'if the travelling and growing metaphors are to be enacted, educators might do well to see

themselves as working in partnership with students, designing learning activities that attempt, in a variety of ways, to place students in a position whereby they can identify new ways of thinking for themselves'. But, we contend, armed with the curriculum themes of language, embeddedness, complexity and metaphor (discussed above), accounting educators and students alike would seem better equipped to pursue 'travelling' and 'growing' conceptions.

THE POVERTY OF ACCOUNTING CURRICULA

The issue of what ought to be an appropriate curriculum for (especially) baccalaureate accounting students is a complex and multi-faceted one. Here we reinforce and extend the argument by Chambers (1999, pp. 250–1) that what we teach students in accounting is tantamount to a 'poverty of discourse' and an 'educational scandal'. Chambers' arguments, as paraphrased by Craig and Amernic (2002, pp. 9–10), are that:

accounting pedagogues have 'turned a blind eye' to the 'fallacious arithmetic' which underpins the variety of accounting they teach—an accounting where the symbols do not 'correspond with the observable facts' (p. 242) ... [They] have failed ... over many decades, to break free of the insulating 'cocoon' of generally accepted accounting practices (p. 249) 'to defend accounting teaching and practice from the infiltration of vague, vagrant and self-serving ideas' (p. 244). As 'expositors' of a variety of accounting with little regard for discovering the critical 'dated money's worth of property in possession' (p. 245) [accounting educators] are implicated as perpetrators of 'specious arguments' that advance 'fallacious' accounting processes leading to 'error, deviousness and plain deceits' (p. 248) [and are] accused of allowing 'indoctrination' and 'brainwashing' to triumph over 'rigorous enquiry'. [Accounting educators] propagate 'illogicalities' and 'inconsistencies', abetted by their 'undisciplined imagination' and failure to focus on the 'observables of real world affairs' (p. 250) [and to] emphasise 'knowledge of the present money's worth of things in possession' (p. 251).

A 'poverty of accounting discourse' emerges from failure to engage more vigorously with the underlying fundamentals of definition, concept and measurement in accounting. It arises when accounting educators ignore or gloss over the importance of ideology and power in constructing both definition and measurement. We should not ignore the view that 'Definitions are interest-driven and saturated with questions of power and persuasion' (Schiappa, 1996, p. 266).

A poverty of accounting discourse will arise from condemning students to an exclusive diet of conventional accounting technique—one that is lacking in the vital trace elements of critique. Chambers, in his address to the 1994 Annual Conference of the Accounting Association of Australia and New Zealand, titled *Pacioli 500 Years On*,²⁰ dwelt on this point. He seemed in an angry mood, barely able to disguise his disapproval of accounting curricula which continued to ignore 'fundamental anomalies' in the beliefs, dogma and principles underlying accounting that 'scream for re-examination in the light of observables and experiences' (p. 2).

²⁰ All references to Chambers in this section, unless otherwise indicated, are from this source. The second author was present.

Specifically indicted by Chambers were the 'going concern assumption', the idea that 'costs attach to outputs', valuation according to 'the cost or market' rule, notions like 'service potential', and 'a whole cluster of ideas on aspects of accounting as it is taught and practised [that] have been plainly described, by accountants themselves, as fictions' (p. 2). He mused tellingly:

Have you ever paused to wonder how long it is since you saw a basic idea in accounting put under critical examination? . . .

You will look in vain for singular and clear concepts of income, wealth, capital, assets, liabilities, financial position, that tally with the phenomena of commercial intercourse. (pp. 2, 3)

Chambers appeared perplexed by the fevered imaginations allowing 'an expectation' to be regarded as an 'asset', and argued that 'nothing in the future can be now' (p. 4). (Perhaps he might have appreciated our contention regarding the importance of making explicit the metaphors in accounting definitions—such as those that inhabit the definition of 'asset'.) He (correctly in our view) could see 'no excuse' for accounting teachers and researchers continuing to propagate 'fictions, flaws and folly' thereby giving succour to a variety of contemporary accounting that is 'logically fallacious and practically pernicious' (p. 2).

Chambers' concerns go to the heart of the issue of the accountability of accounting educators. He seemed to accept, implicitly at least, that the socially constructive nature of accounting definitions would be conducive to clearer, fairer and better accounting education and practice.

If accounting students are to be nourished intellectually, they ought to be encouraged to critique underlying concepts and the social and ideological forces responsible for fashioning any accounting technique. It is important to encourage *social critique* and 'deviations' from the mainstream impositions of the in-vogue conceptions and paraphernalia of the ideology *du jour*, whether it be capitalism, socialism, communism, liberalism or any other ideology. Sadly, fewer professors of accounting seem to conceive their role as 'professing the truth without fear or favour', of leading the way, challenging the status quo, offering critique, 'disturbing the peace', setting the agenda, being the conscience of the profession, and offering 'resistance' to dominant ideologies. This is unfortunate, for we need to pierce the technical surface of accounting to expose the underlying ideology. We need to encourage students to 'see' the seemingly purely technical as inevitably carrying a heavy burden of ideology. We must have students engage in critique. We need to raise their awareness of the implications of ideology that are often obscured by faddishness and technical virtuosity (e.g., as evidenced in the vogue popularity of, for example, economic value added [EVA]).

We would fail in our accountability to society, as 'disturbers of the peace' (Passmore, 1967), if we continue to be obsequious, conformist and complacent and meekly provide little other than a curricular bill of fare dominated by market-driven technical menus (Craig and Amernic, 2002, p. 38). We should resist any temptation to expunge irritating, challenging material because it may offend sensibilities. Sikka and Wilmott (2002, p. 194) capture the essence of the accounting educator's duty when they write:

Accounting is central to the workings of capitalism. It prioritises property rights (as in a balance sheet), celebrates the supremacy of capital over labour (as in the income statement) and encourages belief in efficiency, private profits and competition... Emphasis on its technical aspects tends to displace consideration of accounting's role in representing social conflict. Instead of posing questions about the role of education in legitimizing practices that result in exploitation, poverty wages, environmental degradations and fraud, the issues become those of following the right techniques and/or accounting/auditing standards. In this way the social core of accounting becomes hidden from scrutiny.

Thus, accounting curricula should encourage critique, be informed by ideological awareness, and be served with healthy portions of skepticism. Accounting educators should promote a scholarly environment in which freedom to be skeptical and critical of conventional wisdom is tolerated and actively encouraged. A re-emphasis on critique will provide much-needed antidote to the dressed-up bluster and seductive patina that sustains the mechanics of rather arbitrary, but ideologically laden, accounting techniques such as EVA (as explained by Amernic *et al.*, 2000). Sikka and Wilmott contend that crises such as Enron offer a unique moment during which accounting education may open up accounting's 'social core':

This core only gains public visibility when there are corporate collapses, scandals and revelations of frauds (e.g. Enron and WorldCom). Such moments of crisis weaken the dominant discourses and create possibilities of change. They provide a reminder that aspiring accountants are being taught techniques and values that can fail, have failed, or are failing. However, these moments of crisis are also opportunities for reconstruction, or at least discussion of it. But such discussion is rarely accompanied by questions about the role of accounting education in encouraging antisocial or errant conduct by auditors, company executives or corporate advisors. The connection is rarely made between the professional values and the role of accounting education in the proliferation of social problems. Thus opportunities for reforming education remained confined to the narrow confines of the universities or private mutterings of academics. They are rarely taken beyond the academy. (2002, p. 194)

The collapse of Enron, as a social phenomenon, ought to be regarded as providing a unique opportunity for accounting discourse that shows vividly the intertwining of the technical, the social and the ideological, and which therefore ought to be important in any accounting curriculum.

Dual Mandate

What we should teach in accounting will rarely be a matter for universal accord. But as scholars and educators in professional disciplines within universities, agreement on curriculum is unusually difficult, given the 'dual mandate' we are faced with of 'commitment to traditional academic norms and scholarship... on the one hand, and commitment to the transmission of distinctly vocational skills on the other' (Harman, 1989, p. 471). While we should not submit to control of syllabus by professional accounting bodies, we should be mindful of the need for a rapprochement between the 'academic-scholarly' and 'practice-oriented' cultures that influence curriculum design. We need to strike the right balance between the theoretical and practical components of what we teach in accounting,

and open up our view of what constitutes 'theory' to include critical and rhetorical theory as well. At present, curricula seem out of kilter.

A strong argument can be made that this imbalance arises, in part, as a consequence of the absence of 'any generally accepted view of the role and rationale of the university in the twenty-first century' (Osborne, 2003, p. 22). Although an extensive body of literature exists about the purpose and functioning of the university, much of it is conflicting (Craig and Amernic, 2002, p. 124, fn. 9). This ambiguity of role and purpose poses considerable challenges for curriculum designers, especially in an era where universities increasingly seem to be adopting a functional, vocational and utilitarian role. In this vein, business school academics should 'be extremely wary' about the consequences of unquestioningly embracing a 'creeping corporatism' (Craig *et al.*, 1999, p. 521) and, through their curriculum choices, allowing themselves to become 'cheerleaders for whatever generates profits' (Warde, 2001).

To resolve any problems of dual mandate, to achieve better practical manifestations of the art of accounting, and to attain the 'moral foundation' President Bush craves, we would do well to be cognizant of (and to respond to) the lessons of history and the wisdom of our leading intellectual forebears. Professor Henry Rand Hatfield, for example, in an address to the annual meeting of the American Institute of Accountants on 21 September 1927, criticized accounting practitioners in terms that would resonate as highly apt now. According to Hatfield, practitioners drew strength from their observance of 'principles' without having first built 'a sound theory', used 'loose terminology, shallow and careless reasoning' and conducted themselves with 'apparent eagerness to avoid displeasing [their] clients' (Zeff, 2000, p. 135). Current calls for greater transparency, probity and understandability in accounting repeat Hatfield's arguments:

Accounting is something other than a set of clever devices for beating the income tax with the least damage to one's conscience, something more than a specious way of window-dressing . . . it is the universal language of business.

The prime requisite of language is that it be understandable. There is a suspicion abroad that accounting as it exists today is not impeccable in this respect. Hartley Withers [a financial journalist] . . . speaks of it as an 'impossible cryptogram with an esoteric meaning that is only revealed to an initiated caste, after much fasting and mortification'. (Hatfield, quoted in Zeff, 2000, p. 135)

What was *then* in 1927, according to Hatfield, is *now* too.²¹ Nothing seems to have changed: greed has triumphed over conscience. We still have 'clever devices' (e.g. Enron's special purpose entities) to disguise debt and window dress published accounts. Accounting is no more understandable or less esoteric today than it was in 1927. Indeed, it has become more difficult to unravel as we add more perplexing technical jargon to the accounting lexicon (e.g., terms associated with tax effect accounting and accounting for financial instruments). Accounting education (and Bush's sought-after 'moral foundation') would benefit if our students were required to read more of Hatfield's work and to understand his unwavering value

²¹ Hatfield's dim view of the quality of accounting in the 1920s in the U.S.A. was consistent with that outlined by Berle and Means (1933).

system: 'a commitment to ethical behavior and to accounting practices and terminology that were logical derivations of principle' (Zeff, 2000, p. 153).

One wonders whether accounting practitioners will ever accept such a value system and pay it more than lip service. If not, accounting educators must be held partly responsible—for not instilling in students (the future practitioners of accounting) the value of theory-derived practices. In recent decades such a value system seems to have become *passé* and viewed perhaps as an irrelevant vestige of an 'old economy' mindset. But considering such a value system as an irrelevance is nothing new. When Hatfield addressed the American Institute of Accountants in September 1939, one could be forgiven for thinking that (then) recent events (the Great Crash of 1929, the new regulations of the securities industry in 1933/4, Roosevelt's New Deal and the revelations of the McKesson and Robbins fraud [see SEC, 1940]) would have prompted a greater acceptance of his value system. But this is not what Hatfield observed. Rather, 'he lectured his audience sternly for doing so little to develop a sound theory . . . He counseled the profession, gently but firmly: define theory, have the courage of your convictions, and stop counting noses' (Zeff, 2000, p. 196).

Hatfield's counsel was sound, and is equally applicable to modern day practitioners and accounting academics—despite the best intentions of various (failed) conceptual framework projects throughout the world. Hatfield's advice has met strong support, if not practical embrace, in sections of the accounting academy. Sprouse (1988, p. 121), for example, has averred that 'for accountancy to be acknowledged as a legitimate learned profession, something more fundamental and enduring than facile application of an increasingly comprehensive set of detailed rules and procedures must be at its foundation'. We would be well served too by reflecting on the following very acute observation made by Hatfield in his 1939 address:

The conflict between theory and practice is a false one, for practice to be sound should be related to sound theories . . . practitioner[s] . . . certificates state that in their opinion the accounts are 'in accordance with accepted principles of accounting'. It certainly behooves the profession, therefore, to know what a principle is, and what are the principles of accounting. (Zeff, 2000, p. 196)

Indeed, what Hatfield 'behooves' the profession to do, the philosopher Whitehead (1929/1957, p. 38) sees clearly as a role for the university (and, we contend, the accounting educators within it). Whitehead argues that '[t]he really useful training yields a comprehension of a few general principles with a thorough grounding in the way they apply to a variety of concrete details . . . The function of a university is to enable you to shed details in favor of principles.'

If that is to be the case, we have not progressed far, if Baxter (1981) is to be believed. His view (which we agree with and regard as a good description of practice in 2004) is that accounting curricula are over-weighted with the study of standards and official pronouncements. We suspect that Zeff (1989, p. 165) would agree strongly too: he chides accounting educators for responding to the 'proliferation of accounting pronouncements' by 'increasing the girth of intermediate accounting textbooks' and covering many pronouncements in 'mind-numbing detail', unaccompanied by any discussion of historical development or contradictions

between inconsistent standards. Baxter (p. 10) claims that insufficient attention is given to:

the economic reality the accounts are supposed to show . . . learning by rote replaces reason; the good student of today is he who can parrot most rules. On this spare diet, accounting students are not likely to develop the habits of reasoning and skepticism that education should instill.

Sprouse (1989, p. 107) concurs, and sheets the 'lion's share of the blame' to accounting educators for 'imposing all those rules on their poor defenceless students'.

The philosophical underpinnings of accounting should not be thrown 'out the window' as some form of jetsam. But the task confronting accounting educators is not helped by our penchant for textbook-based courses that we find 'easy to teach from'. We need to be mindful of Whitehead's contention that: 'Whenever a text-book is written of real educational worth, you may be quite certain that some reviewer will say that it will be difficult to teach from it. Of course it will be difficult to teach from it. If it were easy, the book ought to be burned; for it cannot be educational' (1929/1957, p. 16).

Few accounting graduates get a good exposure to the various underlying theories of their discipline. Most are exposed to GAAP, at great length, in the initial years of their study. It is often not until a final year semester-length elective unit, Accounting Theory, that they engage in any (even mild) critique of the accounting practices they have learned by rote. By this time they are already brainwashed into thinking that because accounting techniques are 'generally accepted', then those practices must be good and unchallengeable. Indeed, even when they are exposed to 'theory', such exposure is often perverse and highly delimited because of the theoretical perspectives that are excluded. For example, Scott's textbook *Financial Accounting Theory* (2003) is lavish in description of decision-usefulness and positive accounting theory, but is silent on anything resembling critical theories or rhetoric in its survey of the *theory* of the language of business. And Macintosh (2003, p. 198), in a review of Skinner and Milburn's *Accounting Standards in Evolution*, laments that 'there is major lacuna in the authors' choice of material — especially any material dealing with the historical development of the profession and accounting theory, despite the large corpus of scholarly work with a critical theory perspective'.

The challenge facing accounting educators who want to do more than teach procedures and technical competence, but are uncertain as to how they should meld professional core knowledge with a less gullible, less conservative, more critical social outlook, is not easily resolved. Ravenscroft (pers. comm., 2003) provides an anecdote that is both insightful and depressing:

I remember hearing a MAJOR critical theorist in the USA at an annual AAA [American Accounting Association] meeting sharing with us how he taught critically. I cannot tell you how eagerly I looked forward to this talk . . . and I cannot tell you how incredibly disappointed I was to learn that he was doing no more than I was . . . teaching a standard intermediate text book and supplementing it with articles from the current business

press!!! I admire this person's writing (of which there are many examples) and his persistence in his somewhat lonely theoretical tower, but I admire him less than I used to, because I found out as a teacher he has the same feet of clay I do. He hasn't figured out how to navigate and negotiate the dual mandate either and he's put a lot more effort into it than I have. Technical competence from professionals is not to be scoffed at, YET, we want students to understand the social role, the embeddedness of accounting, its relative nature, its manipulation by political means, its nature as performative utterance rather than as revealed truth, etc . . . How to do both is crucial, key, absolutely what we all want to do and don't know how to do . . . We do not want to create more myopic mechanized machines who spit out tax code rapid-fire and don't question anything they are doing or learning.

Well said. We agree entirely.

GENERATIONS OF INTELLECTUAL IMPOVERISHMENT

Most accounting educators do not require students to read the original writings of the great minds of accounting. More often than not students are left intellectually impoverished by not reading such writings or by being served a menu of sanitized summaries in accounting theory textbooks.²² Accounting education would benefit if students were exposed to the corpus of wisdom (and the 'warts') embodied in the lifetime writings, including private correspondence,²³ utterances,²⁴ and thinking of accounting's major intellectual leaders over time—for example, through exposure to the lifework and thinking of scholars of the stature of Littleton, Paton, Hatfield and Chambers. Such exposure should be used to develop substantive curriculum themes and content.

While accounting curricula often include the occasional examination of one or two works of 'contemporary research heroes', they do not, as a rule, challenge students to analyse the lifework, attitudes and cerebral essence of our eminent forebears. Two good examples of the corpus of written and spoken scholarship worthy of substantive exposure lie in the writing, correspondence and other life's work of Professors Henry Rand Hatfield and Raymond J. Chambers.²⁵ Their

²² The temptation to rely on the convenience of summaries and secondary sources is evidenced by our personal behaviour in compiling much of the following text relating to H.R. Hatfield from the excellent biography by Zeff (2000). Clearly, where access to primary sources is impractical for logistical reasons, as here, secondary sources and summaries must inevitably be relied upon.

²³ See, for example, the exchange of private correspondence between Chambers and Briloff, reported in an editorial in *Abacus*, June 2002, p. ii.

²⁴ Important oral commentaries can be made in places we might not expect. An address delivered by Ray Chambers to the Sydney Rotary Club on 19 January 1971 was the centrepiece of an editorial in *Abacus* in June 2002 (pp. ii, iii).

²⁵ The Fisher Library Archives at the University of Sydney holds the Chambers Collection, containing over 20,000 items of Chambers' correspondence files, 1947–99. There seems to be a welcome renewal of interest in Chambers and his work (see, e.g., Al-Hogail and Previts, 2001). A forthcoming special issue of *Accounting Education: An International Journal* is devoted to analysis of Chambers' case that current curricula in accounting education represent a 'poverty of discourse' (Chambers, 1999).

output deserves to be exposed to students: it provides a wealth of ideas, many contentious, for analysis. Accounting educators should require students to read, analyse and critique some of the thoughts of exemplary paragons of challenging thinking in accounting.

Criticism of the professional standards of practising accountants and accounting educators has a long history that is traceable through diverse settings over many years. Yet we seem to have become totally inured to it, immune to criticism that is counter to the overblown rhetoric of professional excellence and virtue promulgated routinely over many decades by professional accounting bodies.

The criticisms levelled currently at practising accountants and (by implication) accounting educators are not new. For example, Hatfield, in addressing San Francisco CPAs sometime in 1905–6, appealed to his audience to lift their standards of performance. What he had to say about accounting would not be out of place now, almost a hundred years later:

The . . . need of the profession is the establishing of the highest possible standard for its members. I plead not merely for technical dexterity in the investigation of accounts and the detection of frauds; not merely for knowledge derived from prolonged study of the principles of accounting . . . not merely for a high standard of personal probity . . . nor [a] high code of professional ethics . . . The profession should claim all of these, but much more . . .

The most important problem before the public is the regulation of corporations. There are many sides to this problem but most of them center about finances, the question of investment and of profits. In a word, they are questions of accounting. *But there is no other country where such vicious principles of corporation accounting are countenanced as in the United States.* In proof of this, look at the text book on corporation accounting recommended by the N.Y.C.P.A. This explicitly states that there is no objection . . . to listing assets acquired by stock purchase at twice their actual value . . . Is the C.P.A. prepared to take a stand for accuracy in corporation accounts? *May not C.P.A. stand for Conscience, Probity, Accuracy?* (Cited by Zeff, 2000, p. 64, emphases added)

Remarkably, the problems Hatfield alluded to were prevalent in the prelude to the recent spate of corporate collapses. Enron, for example, listed assets such as its 'merchant investments and energy assets' at inflated estimates of their fair value or 'actual [net realizable] value' (Benston and Hartgraves, 2002, pp. 114–17). Even more remarkably, the 'vicious principles of accounting' Hatfield alludes to as then 'still countenanced in the U.S.' are now still in place—and indeed, revered. For example, perhaps the most distinctive characteristic of U.S. accounting, LIFO, can be 'vicious' in its distorting effect on reported profits and inventories. The adoption of LIFO flow assumptions even when they are totally contrary to actual flows of inventory is an example of institutionalized deception. Yet such adoption remains unchallenged, tolerated because of its capacity to alleviate some of the distortions in inventory accounting that arise in periods of rising prices—and because of its compatibility with allowable tax assessment procedures. It reflects a triumph of pragmatism and expedience over principle and propriety.

Hatfield's criticisms persisted over several decades and have been supported then, and since, by a wide variety of accounting scholars. Chambers, for example, in his theory of Continuously Contemporary Accounting is alleged to have

'demonstrated with logic and evidence that only an accounting system based on market selling prices is relevant to users' evaluation and decision-making processes' (Al-Hogail and Previts, 2001, p. 1).

Today, past criticisms of accounting (and by implication of accounting educators) have a familiar ring. It has been heard in commentary on the implication of accounting in corporate crashes, in many countries, over many decades.²⁶ As recent editorials in *Abacus* aptly observe, 'the tone of the rhetoric' (that we observe with recent company collapses) mimics that surrounding like sagas (Penn Central, Equity Funding, S&L in the U.S.; Bond, Adsteam, Cambridge Credit in Australia; and Pergamon, Maxwell, BCCI in the U.K.) in previous decades' (Dean *et al.*, 2002, p. i). Indeed, the responses to on-going creative accounting and failures like that of Enron 'appear to be in an intellectual groove' from which they struggle to emerge (Dean, 2002, p. iii).

With this in mind, there would seem considerable merit in recognizing the importance of a 'historical perspective' in our curriculum choices. We should alert students to the fact that the history of corporate failure is littered with criticisms of accounting and auditing education and practices—and that 'on each occasion . . . reform has been demanded and promised, only to lapse once the outrage has been aired' (Dean *et al.*, 2002, p. i). An historical perspective is important too, for as Funnell (2002, p. 11) appositely observed:

most accounting subjects taught at universities are to some extent dependent on the historical insights provided by accounting historians. Thus, students of financial accounting are unlikely to fully understand the importance of auditing and accounting standards if they do not have a good grounding in the history of the legislative protections provided by governments to shareholders, and society in general, as a result of financial catastrophes over the past two centuries.

Clearly, knowing the history of the highly politicized debate that has taken place over whether to expense stock options and the ethical propriety of external auditors conducting management advisory services for their audit clients would help students to understand the current problems of accounting that have emerged from the Enron collapse.

DISCUSSION AND RECOMMENDATIONS

There is still a misguided view in the broader community, including by Mr Bush and others (including also many in the 'accounting industry') that technical dexterity with the accounts is sufficient. For many, mere compliance with rules-based GAAP, without any professional 'true and fair' or 'fairly presented' override, is acceptable. Furthermore, the whole concept of a 'professional person' and of what that entails seems to have been swept aside or redefined. Perhaps accounting educators need to ponder the words of Sterling (1973, p. 49) on what he regards to be the almost unique approach adopted in preparing novices for service in the

²⁶ For example, in the context of Australia by Birkett and Walker (1974); Chambers (1973); and Clarke *et al.* (2003).

accounting profession: 'Except for some theologies, I don't know of any other discipline that perceives its duty to be the passing along of accepted practices'. Indeed, as Chambers (1994, p. 2) observes tellingly:

In accounting the first and chief qualification of basic ideas is that they be generally accepted. If any one of them is contrary to fact, or inconsistent with another, that is 'just too bad' for facts and logic. The defect is plastered over with another dictum which qualifies forthwith as generally accepted; otherwise there would be no place for the provisos, caveats, exceptions and exclusions that becloud every one of them and confuse the utterances of professional bodies, standards boards and textbook writers.

In Chambers' (1994, p. 4) assessment, we desperately need 'protection from the nonsense parlayed by textbooks and standards boards' and 'the aid of independent thought rather than the dead hand of unwarranted general acceptance and abject compliance'. To encourage 'independent thought' and not 'abject compliance' with accounting practices that are 'generally accepted', we propose three sets of recommendations as a basis for conversation, formal discussion and adoption by accounting educators.

Recommendation 1: Curriculum Themes

The four curriculum themes (outlined above) should be introduced in the first class in accounting and should permeate all subsequent teaching of accounting:

Language Students should be made aware that accounting is the language of business; that it is contested in a way that affects perception, thought and action; and that it serves social, rhetorical and ideological ends. Accounting educators should go far beyond mere parroting of the superficial platitude 'accounting is the language of business', and consider accounting curriculum choices in which *language* is made problematic.

Embeddedness Students should be encouraged *not* to regard accounting as operating in an insulating cocoon but to appreciate it as a profound social and organizational mechanism embedded in the practice of other functional areas of business, such as marketing, and human resources management, and of society more generally.

Complexity Students should be encouraged to appreciate the complexity of accounting through exposure to *real*, as opposed to textbook, accountings. The complex, ideologically laden world in which accounting operates should not be overlooked or trivialized.

Metaphor Students should be encouraged to contemplate the abstract plane of accounting and the metaphors that, often subtly and unnoticed, influence accounting and the way our accountings are perceived.

Recommendation 2: Addressing the 'Poverty of Discourse'

There should be a more determined commitment to address the 'poverty of discourse' in accounting curricula by:

First, engaging more vigorously with the underlying fundamentals of theory, definition, concept and measurement in accounting; and of encouraging a view that good practice needs to be founded on sound theory. As an example, the ideological and rhetorical power of *definition* should be opened up for discussion in the accounting curriculum.

Second, abandoning slavish, unquestioning adherence to conventional accounting techniques and over-preoccupation with uncritical study of extant accounting standards and official pronouncements issued by professional accounting bodies. Accounting educators should serve accounting with lashings of scepticism and should be prepared, even when it offends sensibilities, to encourage critique and deviations from GAAP. In many accounting educational settings, especially those with a professed mandate of 'preparation for entering the profession', this may require real determination on the part of faculty members.

Third, piercing the technical surface of accounting to expose its underlying ideology. We should not operate as unquestioning cheerleaders of any imposed ideology—such as those based on the virtues of market-based competition or of the supremacy of capital over labour.

Recommendation 3: The Lessons of History

Accounting curricula should accord greater cognizance of, and alertness to, the lessons of history and the wisdom and also weaknesses of prominent intellectual forebears in accounting by:

First, encouraging student exposure to the life's work of the great minds of our discipline.

Second, alerting students to the criticisms of the professional standards of practising accountants that have been made over many decades.

Third, alerting students to the long history of unexpected corporate failure: a history littered with criticisms of accounting and auditing practice in which promised reforms have lapsed once the outrage has subsided.

Fourth, at least encouraging an appreciation that some suggestions might support the contention that accounting, in ways still seemingly too subtle for us to comprehend adequately, was (and is) foundational to society's development. As Mattessich (1987, p. 71) observes:

Recent archaeological research offers revolutionary insight about the precursor of abstract counting and pictographic as well as ideographic writing. This precursor was a data processing system in which simple (and later complex) clay tokens of various shapes [represented] assets and economic transactions . . . The economic-philosophic implications of this discovery are important. First, it suggests that accounting preceded abstract counting as well as writing . . .

To sum up, we are all conflicted denizens of a confused, often-absurd world. Our chosen vocation, as accounting educators in the university, should cause us to pause, especially during and after moments of crisis such as Enron, to reflect upon how (imperceptibly even) we might help improve the world through our engagement with what and how we teach, and help lift veils of ignorance, if only slightly.

By encouraging a social view in accounting education, by encouraging critique, and by encouraging a critical enthusiasm for the wisdom of the past, we aim to nudge accounting 'out of the shadows'.

But 'encouragement' of such matters is only the beginning. There is ample scope for further consideration of how the agenda outlined above might be implemented. This would involve deeper analysis of the teaching and learning *processes* that would best support changes in the worldview expected of students. As well, attention needs to be directed to the form of pedagogy (or andragogy) that would best help implement the proposed agenda of reform, and to the ways in which educators might be persuaded to become more open to new ways of thinking.

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APPENDIX

PRESIDENT BUSH'S SPEECH OF 9 JULY 2002

Downloaded from www.whitehouse.gov on 9 July 2002

For Immediate Release
Office of the Press Secretary

July 9, 2002

President Announces Tough New Enforcement Initiatives for Reform
Remarks by the President on Corporate Responsibility
Regent Wall Street Hotel
New York, New York

...

11:20 A.M. EDT

THE PRESIDENT: Thank you all. Thank you very much for that warm welcome. I'm pleased to be back in New York City. New York City is a unique symbol of America's creativity and character and resilience. In the last 10 months, New Yorkers have shown a watching world the true spirit of your city. (Applause.) A spirit that honors the loss, remembers its heroes, and goes forward with determination and with confidence.

People of this city are writing one of the greatest chapters in our nation's history, and all Americans are proud of New York. (Applause.)

I've come to the financial capital of the world to speak of a serious challenge to our financial markets, and to the confidence on which they rest. The misdeeds now being uncovered in some quarters of corporate America are threatening the

financial well being of many workers and many investors. At this moment, America's greatest economic need is higher ethical standards—standards enforced by strict laws and upheld by responsible business leaders.

The lure of heady profits of the late 1990s spawned abuses and excesses. With strict enforcement and higher ethical standards, we must usher in a new era of integrity in corporate America.

I want to thank Bill for his introduction. There's nothing like being recycled. (Laughter and applause.) But thanks for having me. I'm honored to meet your family and Uncle Jack. (Laughter and applause.)

I appreciate very much Secretary O'Neill and Secretary Evans traveling with me today. I want to thank the members of the New York delegation, Senators Schumer and Clinton, as well as Congressman Fossella and Congressman Rangel. I appreciate so very much the Mayor—my friend, the Mayor, for being here to greet me as I came in on the chopper. Thank you, Mr Mayor, and thanks for the great job you're doing for New York. (Applause.)

I'm honored that Cardinal Egan is here. And I appreciate so very much seeing John Whitehead, the Chairman of the Lower Manhattan Development Corporation. And thank you all for coming, as well.

The American economy—our economy—is built on confidence. The conviction that our free enterprise system will continue to be the most powerful and most promising in the world. That confidence is well-placed. After all, American technology is the most advanced in the world. Our universities attract the talent of the world. Our workers and ranchers and farmers can compete with anyone in the world. Our society rewards hard work and honest ambition, bringing people to our shores from all around the world who share those values. The American economy is the most creative and enterprising and productive system ever devised. (Applause.)

We can be confident because America is taking every necessary step to fight and win the war on terror. We are reorganizing the federal government to protect the homeland. We are hunting down the terrorists who seek to sow chaos. My commitment, and the commitment of our government, is total. We will not relent until the cold-blooded killers are found, disrupted, and defeated. (Applause.)

We can be confident because of the amazing achievements of American workers and entrepreneurs. In spite of all that happened last year, from the economic slowdown to the terrorist attack, worker productivity has grown by 4.2 per cent over the last four quarters. In the first quarter of 2002, the economy grew at an annual rate exceeding 6 per cent. Though there's much work left to do, American workers have defied the pessimists and laid the foundation for a sustained recovery.

We can be confident because we're pursuing pro-growth reforms in Washington, D.C. Last year we passed the biggest tax cut in a generation, which encouraged job creation and boosted consumer spending at just the right time. For the sake of long-term growth, I'm asking Congress to make the tax reductions permanent. I'm asking Congress to join me to promote free trade, which will open new markets and create better jobs and spur innovation. I ask Congress to work with me to pass a terrorism insurance bill, to give companies the security they need to

expand and to build. (Applause.) and I will insist on—and, if need be, enforce—discipline in federal spending, so we can meet our national priorities without undermining our economy.

We have much to be confident about in America. Yet our economy and our country need one more kind of confidence—confidence in the character and conduct of all of our business leaders. The American economy today is rising, while faith in the fundamental integrity of American business leaders is being undermined. Nearly every week brings better economic news, and a discovery of fraud and scandal—problems long in the making, but now coming to light.

We've learned of some business leaders obstructing justice, and misleading clients, falsifying records, business executives breaching the trust and abusing power. We've learned of CEOs earning tens of millions of dollars in bonuses just before their companies go bankrupt, leaving employees and retirees and investors to suffer. The business pages of American newspapers should not read like a scandal sheet.

The vast majority of businessmen and women are honest. They do right by their employees and their shareholders. They do not cut ethical corners, and their work helps create an economy which is the envy of the world.

Yet high-profile acts of deception have shaken people's trust. Too many corporations seem disconnected from the values of our country. These scandals have hurt the reputations of many good and honest companies. They have hurt the stock market. And worst of all, they are hurting millions of people who depend on the integrity of businesses for their livelihood and their retirement, for their peace of mind and their financial well-being.

When abuses like this begin to surface in the corporate world, it is time to reaffirm the basic principles and rules that make capitalism work: truthful books and honest people, and well-enforced laws against fraud and corruption. All investment is an act of faith, and faith is earned by integrity. In the long run, there's no capitalism without conscience; there is no wealth without character.

And so again today I'm calling for a new ethic of personal responsibility in the business community; an ethic that will increase investor confidence, will make employees proud of their companies, and again, regain the trust of the American people.

Our nation's most respected business leaders—including many gathered here today—take this ethic very seriously. The Business Roundtable, the New York Stock Exchange, the NASDAQ have all proposed guidelines to improve corporate conduct and transparency. These include requirements that independent directors compose a majority of a company's board; that all members of audit, nominating, and compensation committees be independent; and that all stock option plans be approved by the shareholders. I call on all the stock markets to adopt these sensible reforms—these common-sense reforms—as soon as possible.

Self-regulation is important, but it's not enough. Government cannot remove risk from investment—I know that—or chance from the market. But government can do more to promote transparency and ensure that risks are honest. And government can ensure that those who breach the trust of the American people are punished.

Bold, well-considered reforms should demand integrity, without stifling innovation and economic growth. From the antitrust laws of the 19th century to the S&L reforms of recent times, America has tackled financial problems when they appeared. The actions I'm proposing follow in this tradition, and should be welcomed by every honest company in America.

First, we will use the full weight of the law to expose and root out corruption. My administration will do everything in our power to end the days of cooking the books, shading the truth, and breaking our laws.

Today, by executive order, I create a new Corporate Fraud Task Force, headed by the Deputy Attorney General, which will target major accounting fraud and other criminal activity in corporate finance. The task force will function as a financial crimes SWAT team, overseeing the investigation of corporate abusers and bringing them to account.

I'm also proposing tough new criminal penalties for corporate fraud. This legislation would double the maximum prison terms for those convicted of financial fraud from five to 10 years. Defrauding investors is a serious offense, and the punishment must be as serious as the crime. I ask Congress to strengthen the ability of SEC investigators to temporarily freeze improper payments to corporate executives, and to strengthen laws that prevent the destruction of corporate documents in order to hide crimes.

Second, we're moving corporate accounting out of the shadows, so the investing public will have a true and fair and timely picture of assets and liabilities and income of publicly traded companies. Greater transparency will expose bad companies and, just as importantly, protect the reputations of the good ones.

To expose corporate corruption, I asked Congress four months ago for funding to place 100 new enforcement personnel in the SEC. And I call on Congress to act quickly on this request. Today I announce my administration is asking Congress for an additional \$100 million in the coming year to give the SEC the officers and the technology it needs to enforce the law. If more scandals are hiding in corporate America, we must find and expose them now, so we can begin rebuilding the confidence of our people and the momentum of our markets.

I've also proposed a 10-point Accountability Plan for American Business, designed to provide better information to shareholders, set clear responsibility for corporate officers, and develop a stronger, more independent auditing system. This plan is ensuring that the SEC takes aggressive and affirmative action.

Corporate officers who benefit from false accounting statements should forfeit all money gained by their fraud. An executive whose compensation is tied to his company's performance makes more money when his company does well—that's fine, and that's fair when the accounting is above-board. Yet when a company uses deception—deception accounting to hide reality, executives should lose all their compensation—all their compensation—gained by the deceit.

Corporate leaders who violate the public trust should never be given that trust again. The SEC should be able to punish corporate leaders who are convicted of abusing their powers by banning them from ever serving again as officers or directors of a publicly-held corporation. If an executive is guilty of outright fraud,

resignation is not enough. Only a ban on serving at the top of another company will protect other shareholders and employees.

My accountability plan also requires CEOs to personally vouch for their firms' annual financial statements. Currently, a CEO signs a nominal certificate, and does so merely on behalf of the company. In the future, the signature of the CEO should also be his or her personal certification of the veracity and fairness of the financial disclosures. When you sign a statement, you're pledging your word, and you should stand behind it.

And because the shareholders of America need confidence in financial disclosures right away, the SEC has ordered the leaders of nearly a thousand large public companies to certify that the financial information they submitted in the last year was fair and it was accurate.

I've also called on the SEC to adopt new rules to ensure that auditors will be independent and not compromised by conflicts of interest.

The House of Representatives has passed needed legislation to encourage transparency and accountability in American businesses. The Senate also needs to act quickly and responsibly, so I can sign a good bill into law.

Third, my administration will guard the interests of small investor and pension holders. More than 80 million Americans own stock, and many of them are new to the market. Buying stock gives them an opportunity to build wealth over the long-term, and this is the very kind of responsible investment we must promote in America. To encourage stock ownership, we must make sure that analysts give honest advice, and pension plans treat workers fairly.

Stock analysts should be trusted advisors, not salesmen with a hidden agenda. We must prevent analysts from touting weak companies because they happen to be clients of their own firm for underwriting or merger advice. This is a flat-out conflict of interest, and we'll aggressively enforce new SEC rules against this practice—rules which take effect today.

And the stock markets should make sure that the advice analysts give, and the terms they use, have real meaning to investors. 'Buy' should not be the only word in an analyst's vocabulary. And they should never say 'hold' when they really mean 'sell.'

Small investors should also not have to have the deck stacked against them when it comes to managing their own retirement funds. My pension reform proposal would treat corporate executives the same as workers during so-called 'blackout periods,' when employees are prohibited from trading in their accounts. What's fair for the workers is fair for the bosses. (Applause.)

My reform proposal gives workers quarterly information about their investments. It expands workers' access to sound investment advice, and allows them to diversify out of company stock. The House has passed these measures; I urge the Senate to do the same.

Tougher laws and stricter requirements will help—it will help. Yet, ultimately, the ethics of American business depend on the conscience of America's business leaders. We need men and women of character, who know the difference between ambition and destructive greed, between justified risk and irresponsibility, between enterprise and fraud.

Our schools of business must be principled teachers of right and wrong, and not surrender to moral confusion and relativism. Our leaders of business must set high and clear expectations of conduct, demonstrated by their own conduct. Responsible business leaders do not jump ship during hard times. Responsible leaders do not collect huge bonus packages when the value of their company dramatically declines. Responsible leaders do not take home tens of millions of dollars in compensation as their companies prepare to file for bankruptcy, devastating the holdings of their investors.

Everyone in a company should live up to high standards. But the burden of leadership rightly belongs to the chief executive officer. CEOs set the ethical direction for their companies. They set a moral tone by the decisions they make, the respect they show their employees, and their willingness to be held accountable for their actions. They set a moral tone by showing their disapproval of other executives who bring discredit to the business world.

And one of the principal ways that CEOs set an ethical tone is through their compensation. The pay package sends a clear signal whether a business leader is committed to teamwork or personal enrichment. It tells you whether his principal goal is the creation of wealth for shareholders, or the accumulation of wealth for himself.

The SEC currently requires the annual disclosure of a CEO's compensation. But that information is often buried in long proxy statement—proxy statements, and seldom seen—seldom seen—by shareholders. I challenge every CEO in America to describe in the company's annual report—prominently, and in plain English—details of his or her compensation package, including salary and bonus and benefits. And the CEO, in that report, should also explain why his or her compensation package is in the best interest of the company he serves.

Those who sit on corporate boards have responsibilities. I urge board members to check the quality of their company's financial statements; to ask tough questions about accounting methods; to demand that audit firms are not beholden to the CEO; and to make sure the compensation for senior executives squares with reality and common sense. And I challenge compensation committees to put an end to all company loans to corporate officers.

Shareholders also need to make their voices heard. They should demand an attentive and active board of directors. They should demand truly independent directors. They should demand that compensation committees reward long-term success, not failure. Shareholders should demand accountability not just in bad times, but especially in boom times, when accountability frequently breaks down. Shareholders are a company's most important constituency, and they should act like it.

The 1990s was a decade of tremendous economic growth. As we're now learning, it was also a decade when the promise of rapid profits allowed the seeds of scandal to spring up. A lot of money was made, but too often standards were tossed aside. Yet the American system of enterprise has not failed us. Some dishonest individuals have failed our system. Now comes the urgent work of enforcement and reform, driven by a new ethic of responsibility.

ABACUS

We will show that markets can be both dynamic and honest, that lasting wealth and prosperity are built on a foundation of integrity. By reasserting the best values of our country, we will reclaim the promise of our economy.

Leaders in this room help give the free enterprise system an ethical compass, and the nation respects you for that. We need that influence now more than ever. I want to thank you for helping to restore the people's trust in American business. I want to thank you for your love of the country. And I want to thank you for giving me the chance to come and address you today. May God bless you all. (Applause.)

STEWART JONES, SHEIKH F. RAHMAN AND PETER W. WOLNIZER

Accounting Reform in Australia: Contrasting Cases of Agenda Building

On 4 March 1997, the Department of Treasury of the Australian Government announced sweeping measures to reform standard setting arrangements in Australia (*CLERP Paper No.1*, Commonwealth of Australia, 1997). The Government's agenda is profoundly reformist as it recommended the wholesale adoption of International Accounting Standards by Australian reporting entities, as well as advocating the introduction of market (selling) price accounting both nationally and internationally. While the notion of market value accounting is not new, this recommendation appears to be a historical first from a government, regulatory or standard setting body. Against this background, our study draws on a framework of 'political agenda building' proposed by Cobb and Elder (1972) and Cobb *et al.* (1976), in order to compare and contrast the competing standard setting reform agendas adopted by the Australian accounting profession and the Government. Using the Cobb and Elder framework, we discuss potential reasons why the CLERP agenda has supplanted that of the Australian accounting profession as well as some implications of these developments for the future of standards harmonization.

Key words: Accounting; CLERP; Harmonization; Market price; Standards.

During the 1990s there was significant public interest in and criticism of the institutional arrangements for accounting standard setting in Australia (see, e.g., Walker and Robinson, 1994; Belkaoui and Jones, 2002, pp. 102–7; Peirson, 1998; Brown and Tarca, 2001). Consequently, there have been attempts to reform the standard setting process—on two fronts. The first came from the accounting profession under the auspices of the Australian Accounting Research Foundation (AARF) which commissioned *A Report on the Institutional Arrangements for Accounting Standard Setting in Australia*—the Peirson Report (Peirson, 1990a). While applauded by the Australian accounting profession and the AARF, the Peirson Report failed to win the endorsement of the Australian Government (McGregor, 1995). A second more substantial and reformist accounting standard setting agenda was initiated by the Commonwealth Department of Treasury of Australia (hereafter, the Treasury), as part of its Corporate Law Economic Reform Program (CLERP). This reform agenda was formally announced by the Treasurer,

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the Honourable Peter Costello, in March 1997 (CLERP, *Proposals for Reform, Paper No. 1*, Commonwealth of Australia, 1997, hereafter CLERP 1). The details of the CLERP have been published by the Treasury as *Corporate Law Economic Reform Program: Draft Legislative Provisions* (1998) containing *A Bill for an Act to amend the Corporations Law, and for related purposes*, and *Corporate Law Economic Reform Program: Commentary on Draft Provisions* (1998). The CLERP became legislation in November 1999 (taking effect as of 1 January 2000) as the *Corporate Law Economic Reform Program Act*, 1999 (Part 12, ss 224–38, specifically relates to the new institutional arrangements for accounting standard setting). More recently, CLERP 9 ‘Corporate Disclosure—Strengthening the Financial Reporting Framework’ (September 2002) was released, which provided a number of sweeping recommendations for reform of the auditing profession, as well as detailing recent developments in Australia’s harmonization program.

While both the Peirson Report and the CLERP¹ generally endorsed a U.S.A.-FASB style approach to accounting standard setting, there are significant differences between them. The Peirson Report recommended that the Government relinquish substantial control of the standard setting process. However, the CLERP envisages an expanded role for the Government in accounting standard setting: For example, the Treasurer appoints the chairman and determines the membership of the Financial Reporting Council (FRC), and appoints the chairman of the Australian Accounting Standards Board (AASB). Prior to the CLERP Act (1999), accounting standard setting in Australia came under the auspices of the Commonwealth Attorney-General’s Department. Under the new legislation, accounting standard setting is under the control of the Federal Treasurer (*Companies Law Economic Reform Program Act*, 1999, Part 12, ss 235–6). This constitutes a fundamental shift in standard setting policy away from jurisprudence, administration and law to the realm of national and international economic policy and trade.

A prominent feature of the Treasury’s policy agenda, and the one that has been the principal focus of accounting discourse in the CLERP, is the international harmonization of Australian accounting standards (see Collett *et al.*, 1998; Peirson, 1998; Zeff, 1998; Brown and Clinch, 1998; Brown and Tarca, 2001). Unlike the Peirson Report, CLERP 1 and CLERP 9 advocate the rapid adoption of IASC (now IASB) standards, a deadline subsequently set by the FRC for 1 January 2005 (see IASB Press Release, 3 July 2002; CLERP 9, p. 106). Furthermore, CLERP 1 proposed that adoption of IASB standards can best be achieved by bringing accounting standard setting under the auspices of the Treasury (CLERP 1, 1997; and Part 12, s. 233 of the *Corporate Law Economic Program Act*, 1999).

However, the most striking feature of the discourse on CLERP is not the fixation on the international harmonization of Australian accounting standards *per se*, but the prevalent silence on the profoundly reformist agenda of CLERP 1—the

¹ Henceforward our references to CLERP are specifically to the corporate financial reporting recommendations of Discussion Papers No. 1 (1997) and No. 9 (2002).

introduction of market value (or mark-to-market) accounting. By market value accounting, CLERP 1 means the following:

- in the case of an asset—the amount which could be expected to be received from the disposal of the asset in an orderly market; and
- in the case of a liability—the amount which could be expected to be paid to extinguish the liability in an orderly market (p. 60).

The Government links market value accounting with broader macroeconomic objectives. CLERP 1 states that (pp. 13–14):

the basic purpose of accounting standards is to facilitate the provision of financial information about entities to enable investors, analysts, creditors and the entities themselves to make informed decisions about the allocation of resources. Accounting standards are essentially about disclosure and, in many respects, are at the heart of market efficiency . . . Accounting standards that result in the provisions of accurate and comparable information about the true financial performance and position of business entities promote investor confidence and market integrity, thereby ultimately reducing the costs of capital throughout the economy.

Contrary to the conventional wisdom, CLERP 1 argues that ‘greater use of market value accounting would enable the [capital] market to operate more efficiently through a reliance on enhanced transparency from institutions and corporations in relation to their operations’ (p. 60). CLERP 1 acknowledges that ‘While market value principles have been included in a number of Australian accounting standards (for example, in accounting for the general insurance industry), the method is not favoured by the business community’ (p. 60; see also Walker and Jones, 2003). Notwithstanding this opposition, CLERP 1 advocates market value accounting because it ‘would provide a more informative means of financial reporting for investors, market participants and regulators’ (p. 60). According to CLERP 1, the advantages of market value accounting are that it provides greater transparency, better reflects risk management practices and obviates the need for ledger accounting (p. 60).

This reformist proposal might, at first, appear to be in conflict with that of the international harmonization of accounting standards. It is not. For CLERP 1 states that ‘the proposed AASC [now AASB], having regard to international developments, should seek to promote the use of market value accounting when developing and revising accounting standards that require the valuation of assets and liabilities’ (p. 60). It is apparent, therefore, that the reform agenda of CLERP 1 far transcends the mere institutional arrangements by which Australian accounting standards might be set and harmonized with international accounting standards: It goes to the heart of accounting itself. It contemplates a more contemporary, reliable and informative style of accounting; one that would better inform investors, market participants and regulators about the current financial performance and position of firms; one that would lead to better informed—and hence more efficient—capital markets.

While the notion of market value accounting is not new, this recommendation is—to our knowledge—a historical first from a government, regulatory or standard

setting body. The leading intellectual exponents of market selling price accounting are Chambers (1966; Chambers *et al.*, 1978; Chambers and Dean, 1995, and in several other works—see Chambers and Dean, 1986, 2000) and Sterling (1970, and in several other works—see Lee and Wolnizer, 1997). The leading practitioner exponent of market value accounting is the former Chief Accountant to the U.S. Securities and Exchange Commission, Walter Schuetze (see Schuetze, 2004). Wolnizer (1987) argued that such an accounting would transform auditing into the rigorous safeguard intended by law by requiring auditors to authenticate financial statements by recourse to corroborable commercial evidence independently of the reporting enterprise.

Reporting on interviews with Sir David Tweedie, chairman of the IASB, and other accounting luminaries, *The Economist* (24 April 2003) stated that ‘the way to make [financial statements] more relevant (and to stop executives from fiddling them) is, standard setters believe, to force companies to value more of their assets and liabilities at market prices, to mark them to market’. Sir David Tweedie is reported to have argued that ‘market value is superior to historic cost’. *The Economist* concludes that ‘the slow march to market value is probably unstoppable in the long run, because so many accountants now believe that it is the most intellectually valid way to value assets’.

Against this background, our study has three main objectives:

1. By drawing upon the framework of ‘political agenda building’ proposed by Cobb and Elder (1972) and Cobb *et al.* (1976), to compare and contrast the approaches to accounting standard setting reform proposed by the Australian accounting profession and the Government.
2. To demonstrate that the approach of the Australian accounting profession closely resembles the ‘mobilization model’ to agenda building while that used by the Government corresponds with the ‘insider access’ model.
3. To examine why the Government’s accounting reform agenda has supplanted the institutional accounting standard setting reform agenda of the Australian accounting profession.

AGENDA BUILDING: PHASES AND MODELS

Under a Western democratic system of government, changes in the polity are decided upon in the public arena. Emphasis is often placed on the more visible decision-making processes and what influences them (see, e.g., Schattschneider, 1960; Dahl, 1968). Preceding this public or visible phase of the policy making process is a less visible, but perhaps more crucial, determinant of policy outcomes; namely, the processes by which matters at issue in the polity are screened, articulated, expanded, and eventually propelled into the public decision-making arena. This process has been called *agenda building* (Cobb and Elder, 1972; Cobb *et al.*, 1976),² or earlier, as agenda controlling by Bachrach and Baratz (1962) to describe

² Walker and Robinson (1994) used the Cobb model to describe the political agenda building of competing regulatory agencies in the context of the regulation of cash flow reporting in Australia.

the invisible and perhaps more intangible face of power by which controversial issues in society are either diffused or quashed before they gain access to the public arena (see also Rahman, 1998).

Agenda building is concerned with how and why some public policy issues attract the attention of policy makers and others do not. It has to do with the determinants of the agenda for political controversy within a polity, how the agenda is developed, how it wins the attention of decision makers, and how participants are involved in the political process. In this study, we are concerned primarily with the international harmonization of accounting standards and the potential for the introduction of market value accounting as a public policy question. We are particularly interested in the reasons why it has come suddenly to be integral to the regulatory reform agenda in Australia. The setting, enforcement and quality of accounting standards in Australia have not been free from public criticism and political controversy over the years (see, e.g., ASA Report of General Council, 1966; Walker, 1987). For example, as was evidenced in the recent Royal Commission Report on the failure of HIH (Report, 2003) the quality of conventional accounting standards has been shown repeatedly in corporate failures, takeovers and litigated cases to be technically flawed and unserviceable in the context of financial choice and action. Further, their impact on corporate governance and accountability has not escaped close public scrutiny, particularly in the context of the so-called corporate excesses of the 1980s (Walker, 1993; Wolnizer, 1995; Clarke *et al.*, 2003), and in the more recent spate of failures, including WorldCom, Enron, and closer to home in Australia, HIH and One.Tel. Notwithstanding these events, nothing appears to have captured the corporate regulatory agenda more in Australia today than the issue of international standards harmonization and the quality of accounting standards (see *Final Report*, Royal Commission Report, HIH, 2003).

PUBLIC AND FORMAL AGENDAS

Cobb and Elder (1972) and Cobb *et al.* (1976) distinguish between public and formal agendas. A public (or systemic) agenda consists of the full spectrum of issues that are widely perceived to be socially important and of legitimate governmental concern in a community. Public agendas are formed through the perpetual struggle and clash of social forces as articulated by various interest groups. At any time, the public agenda will reflect the existing balance of social interests in the community, or the mobilization of bias (see Bachrach and Baratz, 1970, p. 58) within a society. Formal agendas, however, represent those issues that have been elevated to formal recognition and are subject to specific consideration by decision makers (Cobb and Elder, 1972; Mitnick, 1980). Agendas of this kind are described variously as being formal, institutional or governmental.

Public agendas are more 'intangible' and broader in scope than formal agendas (Cobb *et al.*, 1976, pp. 126–7). Moreover, the priorities between public and formal agendas can be quite different. While it is possible for an issue to attain access to a formal agenda without having reached public agenda status, this is unlikely to

occur for any issue of major social consequence. One way to achieve access to a formal, governmental agenda is by its proponents attempting to expand its scope, intensity and visibility in the public domain. To attain formal agenda status, a public policy question is likely to be of considerable social importance because high public visibility will draw the attention of political decision makers.

MODELS OF AGENDA BUILDING

Cobb *et al.* (1976) describe three models of agenda building that can be applied to the 'career of an issue'. They identify four phases in that career—its initiation into the domain of the public and/or formal agendas; its specification to the targeted audience; its expansion from one agenda to another; and its entrance on to one or more agendas. The initiation of an issue usually arises from some social conflict, controversy or regulatory gap. The issue may then be specified in terms of a specific grievance or policy proposal by an initiator group and then guided towards agenda entrance. If an issue is not directly placed upon the formal agenda, then its expansion in the public arena may serve to heighten public awareness and facilitate the mobilization of public support in order to persuade decision makers to elevate the issue to the formal agenda. Similarly, decision makers who participate directly in the formal agenda formation process (e.g., the members of a regulatory agency or government department) can mobilize support either for or against an issue or reform proposal. Finally, agenda entrance will occur when decision makers decide that an issue is politically or socially important enough to be placed on the formal agenda (Cobb and Elder, 1972).

In elucidating the various stages in the process of agenda building, Cobb *et al.* (1976) have identified three agenda building models, each of which describes differently the stages in the career of a public policy issue: the 'outside initiative model', the 'mobilization model' and the 'inside access model'.³ The *outside initiative model* describes a situation in which an individual, group or organization outside the government structure initiates or articulates a grievance or issue for reform which they then seek to expand (i.e., publicize) to the public domain. This may take place through media coverage, the public lobbying of politicians, or other forms of publicity with the strategy of pressuring decision makers to place the issue on the formal agenda. Under this model of agenda building, issues are generated at the 'grass roots' level of society and driven into the decision making arena through popular support wielded by special interest groups (Cobb *et al.*, 1976, pp. 28–31). The extent to which the interest groups are organized and visible in the community may vary greatly. Entrance is achieved when an issue is finally included on the formal agenda. However, the elevation of an issue from the public agenda to the formal agenda does not in itself guarantee success of the issue.

³ Cobb *et al.* (1976, pp. 126–38) have used several political and socioeconomic examples to illustrate the different phases of their models. In drawing upon their work, we have selected only the key elements of the models to help explain and illustrate different approaches to accounting standard setting reform in Australia.

Indeed, Cobb *et al.* (1976) have observed that policy issues are often modified significantly or even rejected outright by the decision makers.

The *mobilization model* (see Cobb *et al.*, 1976, pp. 132–5) describes the process of agenda building where institutions or political/institutional leaders seek to move issues from the formal agenda to the public agenda in order to muster the support needed to attain their objectives. Under this model, issues are placed on the formal agenda by the decision makers directly, or by people or institutions with direct access to them. This process is often triggered by a public scandal or systems failure (such as a spate of corporate collapses), followed by the commissioning of a committee of inquiry or some other panel of experts (such as the HIIH Royal Commission). The decision makers may then formally adopt some or all of the committee recommendations in the decision process. This path of agenda building relies on expert opinion and offers some sense of legitimacy to the agenda issues. Initiation of a matter or policy occurs when the decision makers make an announcement about it—the announcement communicates that the issue is on the formal agenda. While there may have been extensive debates about the issue among decision makers prior to the announcement, the public may have little or no knowledge of the issue, given the lack of preliminary expansion to the public domain (Cobb *et al.*, 1976, p. 135). Following the announcement or initiation of the issue, decision makers then elucidate it and explain what they seek from the public. Through this process of specification, they seek to make the issue clear and ‘palatable’ to the public. Mobilization of the issue within the public domain is necessary, however, in circumstances arising when the implementation of a policy requires widespread voluntary acceptance; where decision makers lack institutional or financial support to implement the policy; and when coercion by decision makers is inappropriate, impractical or perhaps too expensive. Decision makers seek to expand an issue from the formal to the public agenda in the same manner that proponents seek attainment of the formal agenda under the outside initiative model (see Cobb *et al.*, 1976, pp. 133–4). That is, there is an attempt to expand the issue to new groups in the population in order to gain the required support to achieve the desired outcomes. Agenda entrance under the mobilization model is achieved when the policy issue is transferred from the formal agenda to the public agenda. While decision makers usually possess greater power and resources to influence issue expansion than, say, outside parties, mobilization efforts can still fail through faulty planning (strategy), poor communication between decision makers, organizational structure problems, or failure to convince lower level agencies of the need or importance of implementing the program.

In contrast to the outside initiative and mobilization models, the *inside access* model describes a pattern of agenda building and policy formulation that seeks to *exclude* public participation in building of the agenda. Under this scenario, the initiators seek to place an issue on the formal agenda and have it dealt with or implemented, usually with the minimum number of changes. If issue expansion does occur, it is usually limited to a few selectively influential groups who are considered important to the passage and implementation of the policy. The issue initiators try to limit issue expansion to the public because they do not want the

issue on the public agenda. Rather, they seek a more 'private' decision within the government, and generally stand to be defeated when the issue is sufficiently expanded to include public groups that might be opposed to it (Cobb *et al.*, 1976, p. 135).

As the name suggests, the initiators are an inside group, such as a government department or regulatory agency. The matter at issue is articulated in the form of a proposal that is usually communicated formally to other government leaders/decision makers. Despite enjoying close ties with the decision makers, the initiator is not guaranteed success because of the complexity and demands of the political process. Consequently, the initiator may seek limited expansion of the issue in question in order to increase its relative priority and standing. Under this model, entrance means gaining formal agenda status as opposed to public agenda status. Notwithstanding that it may be preceded by a large-scale organizational effort behind the scenes, the achievement of formal agenda status is usually neither public nor spectacular.

Being descriptive of complex, social phenomena, Cobb *et al.* (1976, pp. 136–7) acknowledge that their models of agenda building are more conceptual than empirical, and that most real-world occurrences of agenda building will be more complex—combining models as well as agendas. This does not diminish the usefulness of these models of agenda building in the context of our article. Our examination of the accounting standard setting reform processes in Australia suggests that the approach to reforming institutional standard setting arrangements by the professional accounting bodies and the AARF resembles the mobilization model, while the bold approach to reforming accounting by the Treasury corresponds with the inside access scenario. The latter is particularly apparent in relation to the Treasury's advocacy for the international harmonization of Australian accounting standards and the introduction of market value accounting.

AUSTRALIAN ACCOUNTING STANDARD SETTING REFORM AGENDAS

Institutional Arrangements

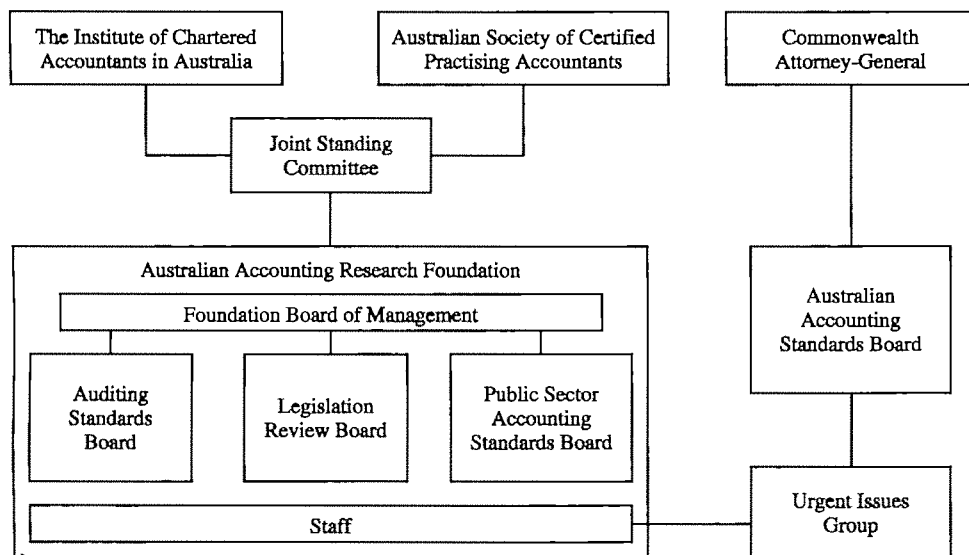
Prior to the CLERP Act (1999), the administrative and functional relationships between the accounting profession, the standard setting boards, the Government and other parties involved in standard setting in Australia are illustrated in Figure 1 below (see AARF *Policy Statement 1*, 1993, Appendix 1, paras 7–13). The Appendix of our article displays the revised standard setting structures required by Part 12, ss 224–38 of the *Corporate Law Economic Reform Program Act* (1999).

The Australian Accounting Research Foundation (AARF) was established on 23 November 1966 by the two major professional accounting bodies—the Institute of Chartered Accountants in Australia (ICAA) and the Australian Society of Certified Practising Accountants (now CPA Australia)—each of which currently contributes equally to the majority of the Foundation's annual operating budget (see CLERP 1, p. 42). The principal function of the AARF was, and remains (albeit in a diminished capacity), to provide technical advice and support to the

ACCOUNTING REFORM AND AGENDA BUILDING

FIGURE 1

INSTITUTIONAL ARRANGEMENTS FOR ACCOUNTING STANDARD SETTING IN AUSTRALIA (PRE-CLERP ACT 1999 (COMMONWEALTH))



Source: Adapted from: Accounting Policy Statement 1, *The Development of Statements of Accounting Concepts and Accounting Standards*, 1993. Reprinted with permission of the Australian Accounting Research Foundation.

standard setting authorities—the Australian Accounting Standards Board (AASB), Auditing Standards Board (AuSB) and, historically, to the now disbanded Public Sector Accounting Standards Board (PSASB). Importantly, the AARF does not have the authority to issue or amend accounting standards. That prerogative resides solely with the AASB.

The AASB (now AASB) was established by the *Australian Securities Commission Act* in 1989. This Act established the Australian Securities Commission (ASC; now the Australian Securities and Investment Commission), including its duties, responsibilities and powers. Figure 1 shows that the AASB, under the pre-January 2000 structure, comes under the aegis of the Commonwealth Attorney-General Department, not the professional accounting bodies, because its functions and responsibilities are specified by statute. Further, the accounting standards applicable to the *Corporations Law*⁴ are those issued by the AASB, and compliance with those standards is compulsory for all reporting entities under that law

⁴ The Corporations Act is a Commonwealth legislation which regulates all aspects of the establishment, operations and winding-up of companies in Australia. It has specific provisions relating to the audit and disclosure of financial statements and conformity with accounting standards.

(AARF *Policy Statement 1*, 1993, paras 6–10). The enforcement of the *Corporations Law* is the responsibility of the ASIC that came within the jurisdiction of the Commonwealth Attorney-General's Department. Under the CLERP proposals, and the 1999 legislation, the chairman of the AASB is appointed by the Treasurer while the other members are appointed by the recently established Financial Reporting Council—the members of which are appointed by the Treasurer (CLERP 1, pp. 35–7, see Appendix A). The Financial Reporting Council takes on an oversight role similar to that of the U.S. Financial Accounting Foundation (FAF) and the U.K. Financial Reporting Council (Peirson, 1998; Hockey, 1999, p. 2). The newly constituted AASB, under the CLERP legislation, has the status of a body corporate and constitutes a Commonwealth authority for the purposes of the *Commonwealth Authorities and Companies Act 1997* (CLERP 1, pp. 35–9).

The PSASB was established under the auspices of the AARF during the early 1980s (AARF *Policy Statement 1*, 1993, paras 11–14) to promulgate 'professional accounting standards', designated as the AAS standard series, applying to all entities not covered by those issued by the AASB (AARF *Policy Statement 1*, 1993, paras 11–14)—principally to public sector entities and not-for-profit entities in the private sector (AARF *Policy Statement 1*, 1993, para. 13). However, subsequent to the implementation of the CLERP, the PSASB was disbanded with the AASB then formulating accounting standards for universal application in Australia. Other boards and committees of the AARF included the AuSB, and the Legislative Review Board (LRB) and Urgent Issues Group (UIG) (CLERP 1, pp. 34–5). The primary responsibility of the AuSB is the promulgation of Statements of Auditing Practice (AUPs) and a conceptual framework for auditing practice in Australia. The LRB monitors the consistency between legislation pertaining to companies and the accounting standards issued by the AASB. The UIG was formed by the AARF and its boards in early 1995 to provide guidance releases on accounting matters considered to be of urgent importance to parties affected by approved accounting standards (AARF, *UIG Charter*, 1997, paras 5–11).⁵

THE ACCOUNTING PROFESSION'S REFORM AGENDA— A MOBILIZATION APPROACH

The strategy used by the Australian accounting profession to advance its institutional standard setting reforms exemplifies the mobilization approach to agenda building as described by Cobb *et al.* (1976). In particular, the professional accounting bodies placed the matter of institutional reform on the formal agenda and sought to obtain sufficient widespread support for their reform

⁵ The UIG comprises sixteen voting members and it releases consensus views on the interpretation of accounting standards (AARF, *UIG Charter*, 1997, paras 13–14). To achieve a consensus, eleven members must vote in favour of a proposed guidance release; not more than two members can vote against any proposed guidance release (AARF, *UIG Charter*, 1997, para. 24). However, the AASB has the right to veto any decision of the UIG (AARF, *UIG Charter*, 1997, paras 26–30).

proposals to attain public agenda status (Peirson, 1990b, pp. 14–15). By reference to the notion of ‘a career of an issue’, we illustrate the ‘fit’ between the accounting profession’s approach to the reform agenda and the mobilization model.

As the initiators, the professional accounting bodies—through the auspices of the AARF—commissioned the Peirson Report (1990a). That Report placed institutional reform of the accounting standard setting process on the formal agenda (Rahman, 1991, pp. 28–31), for the AARF and its boards had close links to the Government. Further, the senior officers of the professional accounting bodies, the AARF and the AASB, had ready access to the Government and senior bureaucrats through existing legislative and administrative arrangements and structures (Miller, 1996, pp. 3–15 for an overview). Augmenting this privileged status (see Cobb *et al.*, 1976) is the authority in respect of accounting standard setting vested in the accounting profession, the AARF and the boards by virtue of the *Corporations Law* (now the *Corporations Act*, 2001). The Peirson Report made clear that the AARF and its boards had long considered current institutional arrangements for accounting standard setting to be inefficient, and that the members of the AASB lacked independence. The major thrust of the Peirson Report was to recommend that Australia adopt the U.S.A.-FASB model of accounting regulation and, in particular, that the AASB be established as an autonomous body independent of the accounting profession, commerce and government. The Report was silent on the substantive matter of the quality of financial statements—and hence the need to reform accounting standards. Consequently, it was silent about how its proposed institutional reforms would deliver better accounting standards and hence a more serviceable style of accounting for informed market choice and action. In contrast, both of these issues are the dominant focus of CLERP 1, and later CLERP 9.

The AARF and its boards carefully communicated the specifications of their institutional reform agenda to the major constituents of the accounting standard setting community in Australia (Rahman and Jones, 1998). The major communications instrument was, of course, the Peirson Report. But the style, format and methods adopted were important elements in the profession’s specification and communication of its reform agenda. The Report included the results of an investigation and evaluation of the standard setting arrangements in the English-speaking world. These international comparisons confirmed the major anomalies and deficiencies of the Australian standard setting model, as perceived by the AARF, especially when compared with institutional arrangements in the U.S.A. Table 1 summarizes the key differences between the Australian and U.S. standard setting arrangements identified in the Peirson Report.

To better align the Australian model with the U.S.A.-FASB model, the Peirson Report recommended that the AARF be autonomous and broadly funded (1990a, p. 7). To enhance their independence and objectivity, board members should be full time and appropriately remunerated (p. 7). Sponsored by the accounting profession, the AARF and its boards, the recommendations of the Peirson Report were *expanded* to the public domain by widespread public endorsement by those

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TABLE 1

INSTITUTIONAL ARRANGEMENTS FOR ACCOUNTING STANDARD SETTING IN AUSTRALIA AND THE U.S.A. (PRE-CLERP ACT 1999 (COMMONWEALTH))

Issue	Australia	United States
Number of members by board/committee	9 ASRB 9 PSASB	7 FASB 5 GASB
Full-time/part-time	Part-time	FASB, full-time GASB, chairman full-time, others part-time
Remunerated	ASRB, chairman receives a salary and members receive sitting fees; PSASB, no	Yes
Consultative body	No	Yes
Funding	By the profession and by government	Broadly based
Number of boards/committees (by type)	2, ASRB and PSASB	3, FASB, GASB & GAO
Voting	Simple majority	Simple majority
Legislative backing	Yes, ASRB No, PSASB*	Yes
Standards issued by	ASRB and AARF	Boards
Non-accountant members possible	Yes	Yes
Independent of the profession, business and government	No	Yes

* Although Australian Accounting Standards developed by the PSASB were not mandated by the Corporations Law, they have statutory endorsement in respect of particular categories of public sector reporting entities.

Source: Adapted from *An Invitation to Comment on Proposals for Reform of the Institutional Arrangements for Accounting Standard Setting in Australia* (Board of Management of the AARF, 1990). Reprinted with permission of the Australian Accounting Research Foundation.

bodies through extensive publicity (see, as an example, AARF *Media Release*, March 1991, pp. 1–2; Peirson, 1990b, pp. 14–15). There was a concerted effort by the AARF to mobilize wider constituent support for the proposals and, thereby, to bring pressure upon government to endorse and implement the recommendations of the Peirson Report.

Working under the commission of the AARF, Peirson published a feature article on key details and rationale for the reform proposals in the prominent and widely distributed practitioner journal, *The Australian Accountant*, in November 1990 (Peirson, 1990b, pp. 14–15). The article provoked a strong public response, most of which appeared to be in favour of the proposed reform agenda (see, e.g., Leo, 1990, p. 21; Prentice, 1990, p. 24; Stevenson, 1990, p. 28). Further, the style of presentation chosen for the Peirson Report implies that it was targeted at a wide audience and prepared for wide circulation. Throughout, the Report adopted

a simple structure and made extensive use of a glossy format, bold highlights and plain English analysis. Another important instrument used by the Board of the Management of the AARF to *expand* the reform issue to the wider constituency in standard setting was their *Invitation to Comment on Proposals for Reform of Institutional Arrangements for Accounting Standard Setting in Australia* (1990, pp. 1–10). This ‘invitation’ was circulated with the Peirson Report and contained a guided questionnaire designed to assist and stimulate public submissions in respect of the findings and recommendations contained in the Report. The documents were distributed by the AARF in 1991 to an extensive mailing list, including all major accounting firms, stock exchange representatives, leading corporations (including the Group of 100), a number of academics and practitioners, and prominent professional and commercial organizations such as the Australian Institute of Company Directors and the Institute of Bankers.

While the public submissions pertaining to the Peirson Report’s *Invitation to Comment* were not released officially by the AARF, it is widely known that constituent interests were generally highly supportive of its major recommendations (McGregor, 1995, p. 20; Belkaoui and Jones, 2002, p. 107). The mobilization strategy of the AARF to gain broad constituent support for the profession’s reform agenda—to ensure its *entrance* onto the public agenda—was successful initially (Leo, 1990, p. 21; Prentice, 1990, p. 24; Starr, 1990, pp. 26–7; Stevenson, 1990, p. 28; Rahman, 1991, pp. 28–31). However, the mobilization strategy of the AARF could only be successful if the recommendations of the Peirson Report were endorsed by government regulators having jurisdiction over standard setting, notably the Commonwealth Attorney-General’s Department (McGregor, 1995, p. 20). However, the Attorney-General’s Department eventually rejected its principal recommendations in a written memorandum to the Executive Director of AARF in December 1991 (see Belkaoui and Jones, 2002, p. 107). In the light of CLERP, one possible explanation for the rejection has been provided by the former executive director of the AARF, Warren McGregor. He notes that the Government’s view was that a prerequisite for legal backing for accounting standards was direct government involvement in the standard setting process (McGregor, 1995, p. 20). In short, the Government did not want to delegate law-making authority to a private sector body such as the AARF or the AASB (McGregor, 1995). It may be thought that the AARF’s mobilization agenda failed because of the ineffectiveness of the profession’s communications with other decision makers (e.g., the Attorney-General and the Treasurer)—the latter were not persuaded then of the merits of the AARF’s reform proposals (see McGregor, 1995; Walker, 1990; cf. Cobb *et al.*, 1976). However, the AARF’s agenda may have failed for a more important reason—it was incompatible with the Government’s agenda for accounting reform: internationalization of accounting standards and the introduction of market value accounting. The Government’s reform agenda is substantial. That offered by the accounting profession was institutionally cosmetic, giving no promise of an improved accounting and better quality financial reporting.

THE GOVERNMENT'S REFORM AGENDA—AN INSIDER ACCESS APPROACH

The Treasury's approach to establishing the reform agenda corresponds with the inside access model described by Cobb *et al.* (1976). The *initiation* of the reform program came directly from the Treasurer who, in July 1997, announced the CLERP. While CLERP has a broad scope—including capital raising, directors' duties and corporate governance, and takeovers—it elucidates an agenda for the reform of accounting standards and the institutional arrangements by which they are to be determined.⁶

Consistent with the inside access model (Cobb *et al.*, 1976, p. 135), the mere announcement of the CLERP proposals by the Treasurer placed the Government's accounting standard setting reform proposals on the formal agenda. The elucidation of those proposals in CLERP 1 constituted the Treasurer's *specification* of the reform agenda. Consistent with the inside access model, those specifications contained a set of concrete proposals which were targeted primarily at other governmental leaders and decision makers (cf. Cobb *et al.*, 1976, p. 135). Cobb *et al.* note that specification of detailed and concrete proposals at the time of policy initiation is important to the inside access approach. This is because of the close time proximity between the initiation of the issue and its implementation. Public debate and other forms of due process are largely excluded in the formal agenda setting process. While there was some opportunity for public comment on CLERP 1, the process was neither deliberative nor extensive. The emphasis on concrete proposals for the reform of accounting and accounting standard setting is explicit in CLERP 1. In this context, three fundamental questions were asked in CLERP 1: Should Australian accounting standard setting arrangements and structures be reformed? Should Australia embrace international accounting standards for domestic financial reporting purposes? And should Australia lead the world in the introduction of market value accounting?

With respect to the proposed reform of institutional arrangements, the Treasurer described in detail the perceived deficiencies of the system of accounting and the institutional arrangements by which accounting standards were established—the majority of which go well beyond those identified by the Peirson Report. Like the Peirson Report, CLERP 1 endorsed, albeit tacitly, the basic features of the U.S.A.-FASB standard setting model for Australia (p. 30). Unlike the Peirson Report, CLERP 1 seeks to reform the outcomes of accounting standard setting—the quality of accounting itself. The Treasurer's points are paraphrased as follows (see CLERP 1, pp. 11–12, 59–60):

⁶ The immediate precursor of the CLERP was an even wider government inquiry into the efficiency and efficacy of the operations of Australia's financial system and financial institutions. This inquiry arose, in part, due to widespread criticism of the relevance and effectiveness of existing regulations in the Australian financial sector, including the general lack of national and international competitiveness in this sector (see 'Financial System Inquiry Final Report', Commonwealth of Australia, March 1997, pp. 1–5). The inquiry was searching for new regulatory structures and approaches which would enhance market competition in the financial system, as well as creating improved measures of financial safety and market integrity for consumers (see 'Financial System Inquiry Final Report', Commonwealth of Australia, March 1997, p. 2).

- the existing arrangements for accounting standard setting are confusing and inefficient (p. 11);
- there is duplication between the AASB and PSASB (p. 11);
- Australian accounting standards are not well understood internationally (p. 11);
- the standard setting process is perceived to be dominated by the accounting profession and there is no real accountability to users of financial statements (p. 11);
- accounting standards do not reflect modern business practices, being too prescriptive and overly technical, thereby imposing excessive costs on business (p. 11); and
- historical cost accounting should be replaced by market value accounting (pp. 59–60).

Consequently, the Treasurer proposed sweeping changes to the institutional arrangements for standard setting, which have now been formalized in the *Corporate Law Economic Reform Program Act 1999* (Part 12, ss 224–38). Unlike the Peirson Report, the CLERP reforms are not silent about how those institutional reforms might lead to a more serviceable form of accounting that is expected to better inform capital markets, reduce the cost of capital for Australian businesses, and enhance investor confidence. These are vital issues. Empirically, they are beyond the scope of our article.

However, we are vitally interested in the Treasurer's agenda to adopt IASB standards, and through their adoption the expectation that Australian standard setters will promote the adoption of market value accounting internationally. That the reformist agenda of CLERP 1 is so profound may explain why the Government adopted an insider access approach to accounting standard setting: the agenda is simply too important, too far reaching, too unconventional to be left to 'outsiders' to design and promote. Continuing the theme of agenda building, and to the *expansion* and *entrance* phases of the inside access model in particular, we now turn attention to this issue.

HARMONIZATION OF AUSTRALIAN AND INTERNATIONAL ACCOUNTING STANDARDS

The most highly publicized and discussed feature of the CLERP is the recommendation that IASB standards be adopted by the newly constituted AASB (CLERP 1, pp. 3–4). CLERP 9 'Corporate Disclosure—Strengthening the Financial Reporting Framework', recommends that the FRC and AASB adopt IASB standards no later than reporting periods beginning on or after 1 January 2005 (p. 106), which will coincide with the timing for the adoption of IASB standards by the EU (p. 104). To assist the FRC in achieving this objective, the Parliamentary Secretary to the Treasurer announced an additional \$A2M in funding to the FRC and AASB, which doubles the Government's contribution to standard setting⁷

⁷ The current contributions from the professional accounting bodies is \$A750,000 annually.

(CLERP 9, p. 102). It is clear from CLERP 9 that adoption of IASB standards would mean the complete replacement of existing AASB standards with those of the IASB (see Jones and Wolnizer, 2003).

Furthermore, to ensure consistent application of IASB standards, CLERP 9 (p. 105) recommends the necessity for Australia to adopt, from January 2005, interpretations of IASB standards issued by the IASB's International Financial Reporting Interpretations Committee (IFRIC). After all, the comparability of a common set of accounting standards could be eroded 'if standards are subject to differing interpretations and markedly different enforcement regimes' (p. 105).

The ideological commitment of the Treasurer to the adoption of IASB standards in Australia is a recurrent theme in CLERP 1 (see p. 24), and later CLERP 9 (pp. 102–6). And the drive for standards harmonization has been rationalized consistently in the context of the Treasury's traditional emphasis on national and international economic policy objectives (CLERP 1, pp. 11–13; CLERP 9, p. 106).

The major recommendations with respect to international harmonization are paraphrased from CLERP 1 as follows (pp. 1–2):

- Australia should continue to harmonize its standards with IASB standards so that compliance with Australian standards will automatically result in compliance with IASB standards (p. 1);
- the prime focus of the proposed AASB should be to influence the development of high quality and relevant IASB accounting standards (p. 2); and
- a key role of the proposed Financial Reporting Council should be to ensure that the AASB is committed to, and works towards, adoption of IASB standards (p. 2).

Under the inside access model, *expansion* of an agenda to the wider public is highly unusual. Consistent with this approach to agenda building, the Treasury apparently did not formally solicit submissions or opinions from any major constituent interest groups in Australia (see Peirson, 1998, pp. 1–4, for a detailed discussion). Indeed, the Treasury appears to have largely bypassed commercial interests and the professional 'authority' of the Australian accounting bodies. Nor has the issue of harmonization even been debated rigorously at the professional level in Australia (Peirson, 1998, pp. 1–4). As a result, there has been no evidence of a groundswell calling for the international harmonization of accounting standards at the grass roots of business and professional communities (i.e., *the polity*), at least in Australia. On the contrary, there has been strong opposition to the wholesale adoption of IASB standards by the business community, the organized accounting profession and academics (see, as examples, English, 1998; Peirson, 1998; *Press Release of Australian Society of CPA's*, 2 June 1998; Zeff, 1998; Emenyonu and Adhikari, 1998, pp. 24–32; Collett *et al.*, 1998; Brown and Tarca, 2001; and Dean, 2004).

Under the inside access scenario, issue *entrance* means successful inclusion on the formal agenda, though not necessarily on the public agenda (Cobb *et al.*, 1976). The CLERP proposals were incorporated into the legal machinery, via the draft legislation, within months of the proposals being published by the

Treasury (see *Parliamentary Press Release*, September 1997). This is evidence of the political influence of the Treasury and its success in placing its institutional accounting reform proposals onto the formal agenda (Collett *et al.*, 1998).

INTERNATIONAL HARMONIZATION: A PROSPECTIVE SOLUTION

For the greater part of its twenty-five-year history, the standards of the IASB predecessor, the IASC, have been engaged in a fervent effort to find a serious audience for its standards (Evans and Taylor, 1982; Mueller *et al.*, 1994). However, the IASC as a global accounting standard setter had, even in its formative years, been continually dogged by suggestions that their standards are more accommodating and flexible than those obtaining in (say) the U.S.A., the U.K., Canada and Australia (Nobes, 1985; Thorell and Whittington, 1994). Further, having regard to the considerable diversity of socioeconomic, legal, political and institutional structures in different countries, the feasibility of a universally acceptable and compatible set of accounting standards (and concepts) has been widely questioned (Nobes, 1985; McGregor, 1999; Evans and Taylor, 1982; Chandler, 1992; Jones and Wolnizer, 2003). Notwithstanding the industriousness of the IASC in accounting standard setting during these years, it had become clear by the late 1980s and beyond that the IASC had not attracted a significant international audience for its standards (see Chandler, 1992; McGregor, 1999).

The faltering quest of the IASC to find a market for its standards in these years eventually led to a significant rethinking of its mission of facilitating the worldwide harmonization of accounting standards (Chandler, 1992; Street and Shaughnessy, 1998). In the late 1980s and early 1990s the then IASC decided to narrow its harmonization agenda to the financial reporting of transnational corporations; and to forge stronger agenda policy links with the so-called 'Group of 4'—Australia, Canada, the U.K. and the U.S.A. (see Street and Shaughnessy, 1998). In order to achieve its new agenda, the IASC targeted the newly established International Organization of Securities Commissions (IOSCO) as a vehicle to gain support and ultimately endorsement of its standards (Chandler, 1992; *World Accounting Report*, 1992).

In order to render IASC standards more palatable to the leading industrialized nations, the IOSCO often advised the IASC to reduce the choices offered and/or eliminate alternative accounting treatments allowable under its accounting standards (McGregor, 1999, p. 160). From the late 1980s, the IASC formally responded to these criticisms by, among other things, issuing an Exposure Draft (E32) on *Comparability of Financial Statements* on 1 January 1989 (Schweikart *et al.*, 1996, p. 113). The IASC also published an invitation to comment on E32 entitled *Towards the International Harmonization of Financial Statements*. Subsequently, the IOSCO became involved in the IASC's Comparability/Improvements project, and was also a member of the IASC's important Financial Instruments Consultative group (see Shiratori, 1994). Despite the apparent close cooperation that developed in these years, the IASC found it exceedingly difficult to secure

IOSCO endorsement for its standards (see Shiratori, 1994; Walker, 1995; Cairns, 1998 as examples).

A historic deal between the IASC and the IOSCO was made in 1995 in which both parties agreed to draw up a work plan for future activity (see Schweikart *et al.*, 1996). This deal had an important role in changing the fortunes of the IASC. The agreement entailed the IASC developing, by 1999, a comprehensive set of core standards which would be acceptable to IOSCO. This would be followed by the IOSCO recommending to member nations the adoption of IASC standards for cross-border offerings and other foreign listings. While the IASC was hampered by a persistent failure to meet its own self-imposed deadlines (Hegarty, 1997; Beresford, 1997), in May 2000 the IOSCO both assessed and finally gave endorsement of thirty key IAS standards, although this support was not unconditional. In the same month the EU proposed that EU member states (Austria, Belgium, Finland, Italy and Luxembourg) should be required to prepare consolidated accounts in accordance with IAS standards, provided that they have been endorsed by the EU as being in conformity with relevant EU Directives (Flower, 2002).

No doubt the recent support for IASB standards by the EU and the IOSCO, coupled by a comprehensive internal restructuring of the IASB,⁸ has influenced U.S. standard setters to work more closely with the IASB on the harmonization issue (Brown and Tarca, 2001, p. 277). These sentiments were reflected in statements of the FASB, at its 18 September 2002 joint meeting with the IASB at the FASB's Norwalk headquarters—a meeting instigated 'As part of a continuing effort to bring about convergence of global accounting standards, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB)'.⁹ A major focus of this meeting was to evaluate current joint projects on business combinations and financial performance reporting and develop a new project on revenue recognition. A major issue was 'eliminating the key differences between existing U.S. generally accepted accounting principles and international accounting standards'.

While the restructured IASB has gained some recent high profile successes, it is premature to evaluate the IASB's current success in achieving its harmonization or convergence objectives. For instance, while the EU and IOSCO endorsements represent significant developments in the globalization of accounting standards, this endorsement was subject to important caveats, the two most important being:

1. *Interpretation*—the IOSCO could insist that multinational entities adopt a particular interpretation in instances where an IASB standard was unclear or silent. This raises the possibility that different national authorities will prescribe

⁸ Under the newly constituted IASB, which took effect in April 2001, there has been a renewed emphasis on developing, among other things, (a) enforceable accounting standards, (b) high quality accounting standards, and (c) bringing about a convergence of national accounting standards (Flower, 2002, pp. 249–50).

⁹ FASB New Release, 'FASB and IASB Will Hold Joint Meeting in Support of Convergence of Global Accounting Standards', 17 September 2002.

different interpretations of particular IASB standards, thus eroding the concept of global standards.

2. *Waiver*—the national regulatory authority of any country could prescribe that a particular aspect of an IASB standard not be applied, where this is contrary to national rules. This could result in a national authority deciding to impose a national rule.

Furthermore, IOSCO recommendations are voluntary on its members, and hence may not result in consistent adoption of IASB standards by member countries. Member nations are also free to require supplementary reconciliation or additional disclosures if deemed appropriate (Brown and Tarca, 2001, p. 275). While the EU has endorsed adoption of IASB standards, it will also be establishing its own authority for assessing relevance and applicability of IASB standards to the EU. According to Flower (2002, p. 273), this is needed because (a) of legal constraints—the EU cannot insist on European multinationals following rules set down by a non-EU body—and (b) is substantial—the EU will not be prepared to run the risk that the IASB will issue a standard contrary to its own basic interests. Hence, they have not given ‘blanket’ endorsement of IASB standards.

While the IOSCO has recommended adoption of thirty core IASB standards for adoption by national securities commissions, the SEC has not followed suit. Lack of support for the blanket adoption of IASB standards by the SEC may ultimately affect the success of the IASB’s harmonization agenda, at least in the shorter term (Leisenring, 1996; Cairns, 1998; McGregor, 1999). For example, if the IOSCO endorses IASB standards for multiple listings and foreign offerings then these standards will of course be applicable to U.S. capital markets. At present, however, companies wishing to enter U.S. capital markets, which includes the majority of foreign listed Australian companies, must comply with U.S. GAAP and SEC listing requirements (Harris, 1996). In view of the possibility that IASB standards might replace FASB standards, the SEC, including many eminent commentators, has been sceptical about the prospect of IASB standards being accepted in U.S. capital markets (Hegarty, 1997; Sutton, 1997; Zeff, 1998; McGregor, 1999). In fact, notwithstanding determined efforts by the IASB to improve the quality of its accounting standards, public criticism of the quality of IASB standards by the SEC and FASB have been commonplace in recent years (see, e.g., Sutton, 1997, 1998; FASB, 1998; Beresford, 1997).

At this time, it appears unlikely that IASB standards will ever replace existing FASB standards for multiple listings and foreign offerings in the U.S. (FASB, 1998, p. 10; Walker, 1995; Sutton, 1997; Beresford, 1997; Sutton, 1998; McGregor, 1999).

While a closer alliance between the IASB and the FASB has developed in recent years, particularly following the EU decision, it appears the IASB still has a very long road ahead to achieve its mission of a globally acceptable set of accounting standards. This sentiment, tinged with hope, was echoed in May 2002 by the Chief Accountant of the SEC, Robert K. Herdman, in his testimony before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises:

there is an immeasurable need for the FASB and the International Accounting Standards Board, or IASB, to converge the high-level principles in their standards in the short-term, rather than the long-term, and so, much more needs to be done. We recognize there is a joint IASB/FASB project on accounting for business combinations. In order to achieve convergence in the short-term, however, the FASB and the IASB have to work together more closely than they have to date. To this end, the SEC has encouraged both the IASB and the FASB to re-examine their agendas in order to speed up their short-term convergence efforts.

And in a recent work, the chairman of the FASB has elucidated the tensions between a principles-based approach to accounting standards setting (favoured by the IASB) and the present rules-based approach of the FASB (Herz, 2003).

Having regard to the historical failure of the IASC and the present conflicts and challenges facing the IASB in achieving a significant international convergence of accounting standards, the proposal of CLERP 1 that market value accounting supplant conventional historical cost-based accounting is powerful. It would achieve a commonly understood international accounting language. It cuts through the conflict of *principles-based* vs *rules-based* approaches to accounting standard setting; it obviates the need for numerous, complex accounting standards; it can be readily implemented in all market-based economies.

The intractability of all current approaches to accounting standard setting—and the apparent overwhelming complexity of achieving a workable convergence in a set of internationally agreed accounting standards—is unlikely to be resolved unless there is a fundamental shift from cost-based accounting to mark-to-market accounting. The challenge confronting the IASB is not how to achieve harmonization/convergence; the vital challenge is how to fix a technically defective and demonstrably unreliable accounting as a guide to financial choice and action in a market economy. That problem has been graphically described by Walter Schuetze, a former Chief Accountant to the SEC, in his testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (2002, pp. 2–3):

I liken our current accounting system to bridges built from timber, which bridges keep collapsing under the weight of eighteen-wheelers. The public demands that expert consulting engineers be called in to oversee the building of replacement bridges. But the replacement bridges keep collapsing under the weight of eighteen-wheelers. More expert consulting engineers will not make the timber bridges any stronger. What needs to be done to fix the problem is to build bridges with concrete and steel. The same goes with accounting. In the 1970s, after the surprise collapse of Penn Central, the auditing profession instituted peer reviews—where one auditing firm reviews the work and quality controls of another auditing firm. In the 1970s, auditing firms also instituted concurring partner reviews, where a second audit partner within the public accounting firm looks over the shoulder of the engagement audit partner responsible for the audit. These procedures have been ineffectual as shown by the dozens of Enrons, Waste Managements, Sunbeams, MicroStrategies, Cendants, and Livents that have occurred since then. Coincidentally, the Financial Accounting Standards Board also came on the scene in the 1970s; it was going to write accounting standards that would bring forth financial statements based on concepts. What happened was that the FASB wrote a mountain of rules that produce financial statements that nobody understands and that can be and are gamed by corporate management. What all of that amounted to was continuing to build timber bridges that keep collapsing under the weight of eighteen-wheelers. We need to

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stop building timber bridges. We need to build concrete and steel bridges. We need to mark to market all assets and liabilities.

International accounting standards based on a mixture of historical cost dates and fair values, however extensively harmonized around the world, will not yield a reliable and transparent accounting. Perhaps without realizing it, the advocacy of market value accounting in CLERP 1 offers the best yet devised accounting that is not only commonly interpretable and intelligible in all market economies, but that will yield informative, up-to-date and transparent financial statements of position and results.

CONCLUSIONS

In the face of recurring unexpected corporate collapses, the decade of the 1990s was a period of intense public scrutiny of institutional arrangements for accounting standard setting in Australia. We have examined the approaches by the accounting profession and the Government to reforming those arrangements. The strategy adopted by the accounting profession under the auspices of the AARF was found to be consistent with the mobilization model of agenda building. It appears that the profession lacked sufficient authority and political influence to bring about an institutional reform agenda. Being confined to institutional changes, the agenda was not reformist and gave no promise of a more reliable and transparent accounting. It failed to gain the support of government.

The reform agenda of the Government, expressed in CLERP 1, was far more significant. While advocating changes to the institutional arrangements for standard setting and the harmonization of accounting standards, CLERP 1 proposed deep and fundamental changes to accounting—the abandonment of historical cost accounting and the introduction of market value (mark-to-market) accounting. The manner in which the Government chose to promote its comprehensive and far-reaching reform agenda was found to resemble closely the insider access model.

By adopting an inside access approach to agenda formulation and execution, the Government has been effective in bringing about a number of significant and rapid reforms to standard setting arrangements to Australia. Not only has the Treasury avoided any widespread debate on the harmonization issue, it formalized the CLERP proposals in the form of legislation in a very short span of time. Notwithstanding the Treasury's success in placing the international harmonization of Australian accounting standards on to the formal agenda, via the CLERP proposals and the legislation arising therefrom, the vital challenge to bring about a revolution in accounting remains to convince international accounting standard setters to abandon cost-based accounting, with its myriad concepts and rules, and to implement market value (mark-to-market) accounting.

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APPENDIX

STANDARD SETTING REFORMS SUMMARIZED FROM THE CLERP AND PART 12 OF THE *CORPORATE LAW ECONOMIC PROGRAM ACT, 1999* (COMMONWEALTH)

Financial Reporting Council

- To improve participation in the standard setting process, an advisory group called the Financial Reporting Council (FRC), has been created with responsibility to oversee the setting of accounting standards, and particularly the adoption of internationally accounting standards (*Corporate Law Economic Reform Act, 1999*, Part 12, ss 225, 232, 235A).
- Under the new legislation, the Treasurer will appoint the chairman of the FRC, and identify bodies to be represented on the FRC and appoint persons to sit on the FRC from nominated representatives (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 235A).
- The FRC will appoint the members (other than the chairman) of the new standard setting body, to be called the Australian Accounting Standards Board (AASB), which will replace the existing Australian Accounting Standards Board (AASB). The FRC will also attend to the priorities and business plan of

ACCOUNTING REFORM AND AGENDA BUILDING

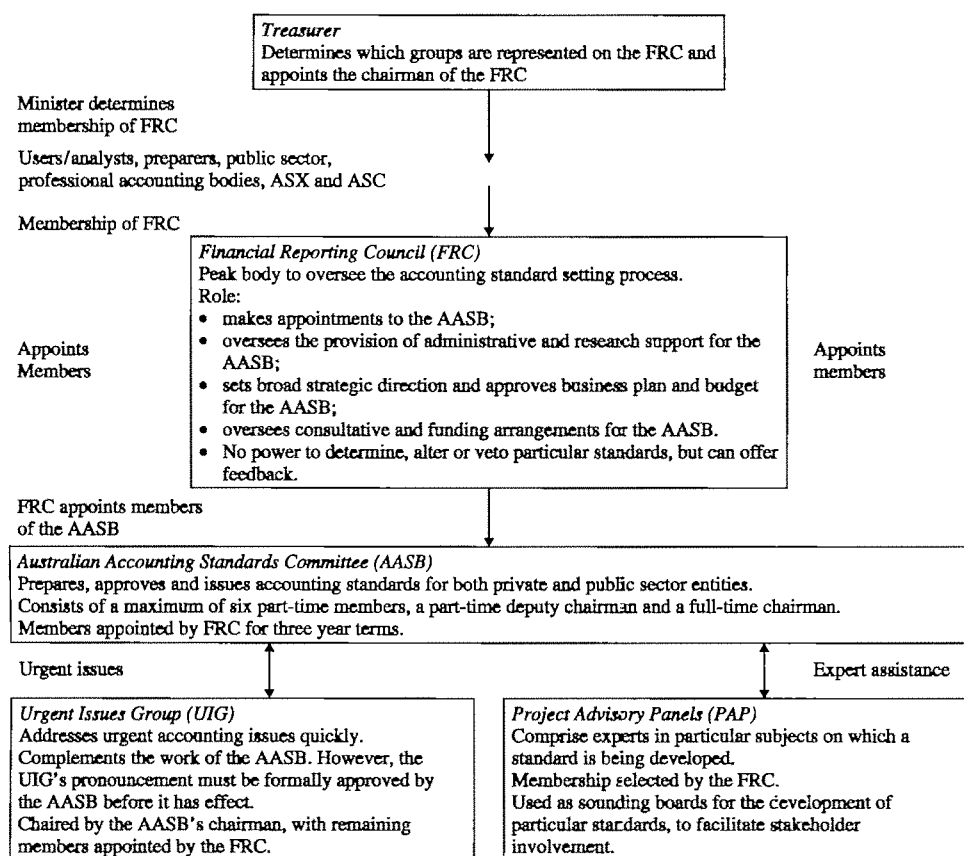
the AASB, provide technical support and so on (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 225).

New Standard Setting Board

- The new AASB will have the powers of a body corporate, which will enable it to operate on a commercial revenue-generating basis (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 226).
- The functions of the AASB will be to prepare, approve and issue accounting standards for private and public sector entities required to prepare financial

FIGURE A1

NEW STRUCTURE FOR AUSTRALIAN STANDARD SETTING ARRANGEMENTS REQUIRED BY CORPORATE LAW ECONOMIC PROGRAM ACT 1999 (COMMONWEALTH)



Source: Adapted from CLERP 1, Appendix B, and the *Corporate Law Economic Program Act, 1997*, Part 12 (Cwlth). Reprinted with permission.

statements in accordance with accounting standards (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 227).

- The FRC will determine the precise size and make-up of the AASB in light of moves to harmonize and eventually adopt IASB standards (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 225).
- Members of the AASB are to be appointed on the basis of ability, in particular their experience in, or knowledge of, accounting, finance, business (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 236B).
- The AASB is obliged to follow the strategic direction determined by the FRC and its general policy directions (*Corporate Law Economic Reform Act, 1999*, Part 12, s. 232).
- Initially, and subject to the views of the FRC, the AASB would desirably consist of six part-time members, together with a part-time deputy chairman and full-time chairman (eight in total). The chairman should be appointed by the Treasurer with the remaining members appointed by the FRC (CLERP 1, 1997, Appendix B).
- Project Advisory Panels of experts on particular subjects being considered by the AASB should be used as sounding boards from the early stages and throughout the development of particular standards to facilitate stakeholder involvement in the making of accounting standards (CLERP 1, 1997, Appendix B).
- Meetings of the AASB should be held in public.
- The AASB would need a maximum of six part-time members, a part-time deputy chairman and a full-time chairman. This approximates the numbers of members of the U.S. Financial Accounting Standards Board (FASB), although it is noted that the members of the FASB are all full-time (CLERP 1, 1997, Appendix B).

CAROL A. ADAMS AND KEN J. MCPHAIL

Reporting and the Politics of Difference: (Non)Disclosure on Ethnic Minorities

This article is based on two related research questions. First, what is the level of disclosure on ethnic minorities in the two sectors of the U.K. economy that historically have employed the most ethnic minorities: the banking and retail sectors? And secondly, what influences the (non)disclosure? It specifically investigates the level of disclosures from 1935 to 1998 and situates them within the changing social, political and economic context of this period. It is contended that the changing pattern of disclosure during this period can be understood with reference to changes in the political strategies for managing the threat of racism adopted by successive governments. The article provides some tentative theoretical reflections on the nature of the racism problematic and the way in which power may be seen to operate through (non)disclosure in this particular instance.

Key words: Accountability; Ethnic minorities; Reporting; Social.

Over the past decade or so the burgeoning literature on corporate social disclosure has tended to focus on environmental reporting (Cowen *et al.*, 1987; Patten, 1992; Roberts, 1992; Burritt and Welch, 1997) and, as yet, we know comparatively little about corporate disclosure on ethnic minorities.¹ The dearth of systematic studies in this area seems particularly surprising given the social and political significance of the issue of racism. Gilroy (1987) for example comments that racism is one of 'the most political forces in Britain today', a claim that is based on an awareness not only of the use of racialized categories in the subjugation of labour, but also in the way in which these categories function dialectically as a source of resistance.

¹ The term ethnic minorities is used in this article in recognition that people from a diverse range of ethnic backgrounds may feel that they are discriminated against. However, our review of the literature found that most documented cases of discrimination in employment in the U.K. during the period we studied have been directed towards those of Afro-Caribbean or southern Asian origin.

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This article attempts to address this lacuna within the literature and is based on two related research questions. First, what is the level of disclosure on ethnic minorities in the two sectors of the U.K. economy that historically have employed the most ethnic minorities: the banking and retail sectors (Dickens *et al.*, 1988; Collinson *et al.*, 1990; Jewson *et al.*, 1992)? And second, what influences the (non)disclosure?—and what might be inferred about the way power may be seen to operate through reporting in this particular instance? It is not the purpose of this article to specify what companies *should* report, but rather to examine the social, political and economic context to shed light on why they do or do not disclose. What companies should report has been considered elsewhere. Adams and Harte (2000), for example, suggest that companies should disclose information on: corporate policies with respect to equal opportunities; the manner in which, and the extent to which, corporate policy has been achieved; the results of monitoring and targets for the employment of minority groups in various roles and positions within the organizational hierarchy; information concerning formal investigations, for example by statutory equal opportunities bodies, and court cases involving the organization on equal opportunity issues; and the involvement of workers and statutory authorities in the development of policy and monitoring of achievements.

Prior work which examines corporate social reporting over a longitudinal period includes Hogner (1982), Burchell *et al.* (1985), Tinker and Neimark (1987), Guthrie and Parker (1989), Arnold and Hammond (1994), Adams and Harte (1998), and Buhr (1998). Interestingly, these longitudinal studies are largely unsupportive of legitimacy theory which has been widely supported by researchers to explain social and environmental disclosures in studies examining reporting at a particular point in time (see, e.g., Patten, 1992; Deegan and Gordon, 1996; Hackston and Milne, 1996; Deegan and Rankin, 1997; and the special issue of the *Accounting, Auditing and Accountability Journal* in 2002 entitled 'Social and Environmental Reporting and its Role in Maintaining or Creating Organizational Legitimacy'). Longitudinal studies allow consideration of the changing social, political and economic context in which nondisclosure occurs (but see Buhr, 1998, and Hogner, 1982, both longitudinal studies which provide some support for legitimacy theory). Also notable is that few prior studies have tried to explain the lack of disclosure. Adams and Harte (1999) is an exception.

Differences in findings based on the length of the study and the variables examined indicate the complexity of influences on corporate social disclosure and the inadequacies of current theorizing (see Adams, 2002). Longitudinal studies also differ in the extent to which they argue that companies are influenced by, or themselves influence, the social and/or political agenda. Burchell *et al.* (1985) demonstrate the heavy influence of the political agenda on the rise and fall of value added statements in company reports in the U.K. Arnold and Hammond (1994) found that information on the employment of Blacks in South Africa by signatories to the Sullivan Principles was used to influence the social and political climate consistent with corporate interest to provide a 'moral rationalization for continuing business in South Africa in the face of a growing movement for

divestment' (p. 531). In analysing the role of women as portrayed in the corporate annual reports of General Motors from 1917 to 1976, Tinker and Neimark (1987) supported a Marxist political economy approach although Cooper and Puxty (1996) argued that the focus on the economic in their study was at the expense of the social. In examining (non)disclosures with respect to the employment of women over a fifty-nine-year period, Adams and Harte (1998), in contrast to Tinker and Neimark (1987), found that the influence of patriarchy was stronger than the influence of capitalism in determining women's employment patterns and disclosure thereof. (Non)disclosure was particularly found to be influenced by the social and the political rather than the economic.

Within the critical literature, the development of the race issue in the U.K. during the period studied here has been viewed predominantly from a Marxist perspective. Since Cox (1970) proposed that the origin of racial prejudice was linked to the development of capitalism, the concept of racism has become increasingly central to contemporary Marxist critique and critical analysis in general (Miles, 2000). Although Cox (1970) specifically argued that racism is a bourgeois rationalization of capital's exploitation and degradation of labour, critical interest in race now views the use of racialized categories not only as a mechanism in the subjugation of labour but also as a source of resistance. Gilroy (1987), for example, contends that racism is one of 'the most political forces in Britain today'.

This longitudinal study examines (non)disclosure with respect to a specific type of social reporting, the employment of ethnic minorities, thereby allowing a detailed examination of the social, political and economic context of (non)disclosure. In doing so, the appropriateness of applying the prevailing Marxist analysis of racism to (non)disclosure is considered.

One further point of clarification may be helpful for readers. In the following discussion of ethnic minorities and the race problematic we use the term 'Black' as a historical, political and ideational signifier, rather than as descriptor of skin colour. Hall (2000, p. 149) appositely explains this usage:

Black is not a question of pigmentation. The Black I am talking about is a historical category, a political category, a cultural category. In our language, at certain historical moments, we have to use the signifier. We have to create an equivalence between how people look and what their histories are. Their histories are in the past, inscribed in their skins. But it is not because of their skins that they are Black in their heads . . . Black was created as a political category in a certain historical moment. It was created as a consequence of certain symbolic and ideological struggles.

METHOD

This work is based on an empirical analysis of the disclosures on ethnic minorities² made by large companies in the retail and banking sectors during the period 1935–98. Figure 1 shows the companies included in the sample, and the

² When considering whether disclosures referred to ethnic minorities we included any reference to nationality, national origin, ethnic origin, ethnic background, colour and race. This is consistent with the definition of the groups protected by the Race Relations Act, 1976.

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FIGURE 1

PERIODS FOR WHICH CORPORATE ANNUAL REPORTS WERE AVAILABLE

Banks	
Bank of Scotland	1935–98 except 1963
Barclays	1935–98
British Linen Bank	1935–67 except 1964 and 1966 ^a
Clydesdale	1935–93 except 1944 and 1962
Lloyds/Lloyds TSB	1935–98 except 1994
Midland	1935–98
National Commercial Bank of Scotland	1958–68 ^b
National Provincial	1935–68 ^c
Westminster/National Westminster	1935–98
Royal Bank of Scotland	1935–98
Retail sector	
Boots	1935–98 except 1975
British Home Stores/Storehouse	1935–98 except 1950
Burton	1935–93 except 1935, 1941–47, 1953, 1964
Great Universal Stores	1935–98 except 1949
Marks and Spencer	1935–98
Sears	1935–98 except 1962 ^d
W. H. Smith	1935–98 except 1935–47
Woolworths/Kingfisher	1935–98

^a Merged with the Bank of Scotland in 1969.

^b Merged with the Royal Bank of Scotland in 1969.

^c Merged with the Westminster in 1968 to become the National Westminster (hereafter Nat West).

^d No report in this year—company taken over.

years for which we were able to obtain their corporate annual reports.³ The selection of the banking and retail sectors drew on advice from researchers at the Commission for Racial Equality⁴ and a review of pertinent empirical research studies which focused on specific sectors of the British economy (e.g., Dickens *et al.*, 1988; Collinson *et al.*, 1990; Jewson *et al.*, 1992). It indicated that clerical and retail employment within these sectors have emerged as important sources of ethnic minority, as well as female, employment during last century. In order to create

³ Annual reports were obtained from: the companies included in the sample; the archives of the Bank of Scotland, Clydesdale Bank and Royal Bank of Scotland; Companies House in Cardiff and Edinburgh; microfiche obtained from Microform; the corporate annual report archive of the Wards Trust Research Library, Department of Accounting and Finance, University of Glasgow; and the University of Strathclyde.

⁴ Data were also collected on gender (see Adams and Harte, 1998).

a research sample of manageable proportions, we focused on higher profile, higher employment, high street clearing banks and the multiple (non-food) retail sector. In the absence of adequate data on employment, firms were selected based on market capitalization. Drawing on two sectors (while admittedly biased), allowed the contrast between ethnic minority reporting practices in different parts of the economy. Firms were selected on the basis of current financial size as measured by stock market value at the time of selection. At that time the sample represented more than 70 per cent of the sectors.

Data for this longitudinal study were collected from annual reports using content analysis.⁵ This technique has been used widely in determining the extent and nature of corporate social reporting (see, e.g., Guthrie, 1982; Guthrie and Mathews, 1985; Guthrie and Parker, 1990; Adams and Roberts, 1995; Adams, Hill *et al.*, 1995; Gray *et al.*, 1995). The research instrument used was based on a model developed by Adams, Hill *et al.* (1995) and is a development of that used in Adams, Coutts *et al.* (1995).

Disclosures were drawn from the corporate annual report. Although the nature of corporate reporting has changed in recent years, particularly with the advent of the Internet, the corporate annual report was the main form of corporate communication throughout the period studied and, particularly in the case of quoted companies, is widely available. It is important to note here, that although companies in Britain are legally responsible for ensuring equality of opportunities (for some 'minority' groups, such as women, ethnic minorities and disabled people), they are not required to be publicly accountable for their equal opportunities policies, activities or outcomes with respect to ethnic minorities. Nor do they have to submit these data to any government body or agency, except in the event of a formal investigation by the Commission for Racial Equality (CRE).⁶

The period 1935–98 was chosen for a number of reasons. This period encompasses times of very different economic conditions, for example: the Second World War, the post-war boom and prosperity, labour shortages, and rising unemployment. Secondly, attitudes towards racism (as reflected in legislation and immigration policy) also changed perceptibly during this period. Immigration was first encouraged, then discouraged. While at the beginning of the period racial discrimination was both widespread and socially acceptable, towards the end of the period it was at least legally unacceptable (Sivanandan, 1976; Fryer, 1984; Wrench, 1989; Bowling, 1996; Pilkington, 1996; Real World Coalition, 1996). We contend that studying the social and political context in which corporate disclosure takes place can potentially assist in understanding corporate disclosure or nondisclosure on ethnic minorities. Archival research was therefore used to gather information about the population and the social, political and economic context.

⁵ For a discussion of how the data were collected, see Adams and Harte (1998).

⁶ There is, however, a requirement to disclose policy in respect of disabled employees, but not activities to ensure policies are achieved or outcomes: Companies Act 1985, Sch. 7 para. 9 (see Gray *et al.*, 1996).

RESULTS

An initial review of disclosures on ethnic minorities from 1935 to 1998 by the sampled companies is presented in Figure 2. It appears that disclosure and non-disclosure by these companies falls into three distinct periods. The remainder of this section explores the changing social, political and economic conditions across these three periods in an attempt to understand this pattern of (non)reporting and contribute to the literature on motivations for disclosure (see Hoogvelt and Tinker, 1978, and Tinker and Neimark, 1987, for other periodization studies). The periodization of the study is summarized below.

The first period extends from 1935 to 1975 and is characterized by a complete lack of ethnic minority reporting by the companies studied. It covers the Second World War, the 1945 to 1950 post-war Labour government, the 1950 to 1964 Conservative governments and period of post-war prosperity, and the Labour governments between 1964 and 1975. For most of this period there was what has been termed a *colour blind* (see Fine *et al.*, 1997, and Jones and Novak, 1999) approach to Black employment; that is, a refusal to recognize and act on the different experiences of Black people in employment in the U.K. (see Wrench, 1989, and Bagilhole, 1997). Racism amongst white workers and in trade unions was widespread (see, e.g., Commission for Racial Equality [CRE], 1981; Fryer, 1984; Real World Coalition, 1996; Wrench, 1989).

The second period extends from 1976 to 1990. During this period references to race begin to appear in a minority of company annual reports. These disclosures generally take the form of equal opportunities policy statements. This period begins with the Race Relations Act of 1976, Labour governments followed, and 1979 saw the beginning of thirteen years of Thatcher Government. Just before the beginning of this period the racist attitudes of trade unions began to change, a process which gathered momentum in the face of increasing right wing racist rhetoric (see CRE, 1981; Fryer, 1984; Wrench, 1989).

Finally, the third eight-year period from 1991 to 1998 is characterized by a significant increase in disclosures on ethnic minorities. During this period the majority of sampled companies report on equal opportunities with a few disclosing information other than bland policy statements. In 1997 the election of Tony Blair's 'New Labour' Party brought to an end many years of Conservative government.

The remainder of this section attempts to locate the reporting practices outlined in Figure 2 within their social, political and economic context.

PERIOD ONE, 1935–1975: LACK OF REPORTING ON ETHNIC MINORITIES

The period from 1935 to 1975 failed to reveal any disclosures relating to ethnic minorities in either the banking or retail sector. This is despite there being a number of interesting features in this period with regard to both immigration and race relations. The lack of disclosure persisted despite significant socioeconomic

SOCIAL REPORTING ON ETHNIC MINORITIES

FIGURE 2

SUMMARY OF PERIODIZATION

Date	Retail	Banking
1935-75	—	—
1976	M&S	
1977	M&S	
1978	M&S	
1979	M&S	
1980	M&S	
1981	M&S	Nat West
1982	M&S	
1983		
1984		Nat West
1985	Boots	
1986		Nat West ^a
1987		
1988	M&S, Woolworth	Lloyds, Midland ^a
1989	Boots, M&S, Woolworth	Lloyds
1990	Boots, M&S, Woolworth,	Lloyds
1991	Boots, M&S, Sears, W. H. Smith, Woolworth	Barclays ^a , Clydesdale, Lloyds, Midland ^a , Nat West ^a
1992	Boots ^a , Sears, W. H. Smith, Woolworth	Bank of Scotland ^a , Barclays, Clydesdale, Lloyds, Nat West, Royal Bank of Scotland
1993	Boots ^a , Burton, Sears, W. H. Smith, Woolworth	Bank of Scotland ^a , Clydesdale, Lloyds, Nat West, Royal Bank of Scotland
1994	Boots, Kingfisher, Sears, W. H. Smith	Bank of Scotland ^a , Barclays ^a , Lloyds, Midland ^a , Nat West ^a , Royal Bank of Scotland ^a
1995	Boots ^a , Kingfisher, M&S, Sears, Storehouse, W. H. Smith	Bank of Scotland ^a , Barclays ^a , Lloyds TSB ^a , Nat West ^a , Royal Bank of Scotland
1996	Boots, Kingfisher, Sears, W. H. Smith ^a	Barclays ^a , Lloyds TSB, Nat West ^a , Royal Bank of Scotland
1997	Boots, Kingfisher, M&S, Sears, W. H. Smith	Barclays ^a , Lloyds TSB ^a , Nat West ^a , Royal Bank of Scotland
1998	Boots ^a , M&S, Kingfisher, Sears, W. H. Smith	Barclays ^a , Lloyds TSB ^a , Nat West ^a , Royal Bank of Scotland ^a

^a Disclosure is more than just an equal opportunities policy statement.

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FIGURE 3

EQUAL OPPORTUNITY DISCLOSURES WHICH SPECIFICALLY MENTION RACE OR ETHNIC ORIGIN, ETHNIC MINORITY, POPULATION DATA AND KEY EVENTS: PERIOD ONE

Date	Retail	Banking	Population data*	Key events
1935-75	No disclosures	No disclosures	No. (proportion) of ethnic minorities in population: 1951: less than 50,000 1961: less than 500,000 (less than 1% of population) 1971: 1.25-1.5 million (between 2.3 and 2.8% of population) Proportion of registered unemployed: 1948: 1.2% 1959: 1.6% 1964: 1.3%	1948: British Nationality Act; first ships carrying immigrants from West Indies arrive 1958: Notting Hill 'white' riots; Institution of Race Relations established 1962 and 1968: Commonwealth Immigrants Act 1965: Race Relations Act, but did not cover employment 1967: National Front formed (Bowling, 1996) 1968: Race Relations Act 1971: Immigration Act 1971: UN General Assembly designated 'International Year to Combat Racism and Racial Discrimination' 1972: Asians expelled from Uganda, 27,000 of whom come to Britain 1973: National Front obtains 16.3% of votes in West Bromwich by-election

* Sources: Banton (1955); Great Britain Office for National Statistics (1965); Office of Population Censuses and Surveys (1981); Peach and Winchester (1974).

changes and legislative developments (see Figure 3). In this section we delineate this context, then briefly discuss the lack of disclosures.

In the period of severe economic depression between the two World Wars, Black people, like women, were regarded as inferior and the preferences of white workers and trade unions not to work with them resulted in sackings and blatant discrimination (see Fryer, 1984). In the aftermath of the Second World War, many people from the colonies were actively encouraged to come to the U.K. to redress labour shortages. Figure 4 indicates that while the British Nationality Act 1948 encouraged people from the Commonwealth to enter Britain, the legislation thereafter became more restrictive. Despite labour shortages, demands for restrictions to the employment of Black people by white workers and trade unions continued throughout our first period and were widespread (Wrench,

SOCIAL REPORTING ON ETHNIC MINORITIES

FIGURE 4

BRITISH IMMIGRATION LEGISLATION, 1935-1975

British Nationality Act 1948: British passport holders from throughout the Commonwealth given the right to enter Britain freely with their families and live and work in the U.K.

Commonwealth Immigrants Act 1962: Limited the right of Commonwealth people with British passports. Immigrants had to obtain an employment voucher before they came.

Commonwealth Immigrants Act 1968: Immigration to Britain was restricted to those people from the Commonwealth who could prove their parents or grandparents were born in the U.K.

Immigration Act 1971: Only people born in Britain or whose parents were born in Britain had a right to live in the U.K. Others had to obtain a work permit. Male work permit holders could bring their wives and children to the U.K., but female work permit holders could not bring their husbands and children.

Source: Page and Newman (1985).

1989). Thus, throughout this period, the economic wellbeing of an individual was significantly influenced by the hatred engendered towards Black people. Consider the 1958 'white' riots in Notting Hill where many Blacks lived in overcrowded conditions. Bowling (1996) and Pilkington (1996) describe in some detail the actions of whites who allegedly started the violence. Their accounts make grim reading. It is clear from these sources and eyewitness accounts quoted in them that the main source of the white hatred was the difference in both lifestyle and physical appearance of Blacks. At this time of high levels of employment and labour shortages in some sectors, there was no real threat to the jobs of whites. The Government's response, however, as seen in the Commonwealth Immigrants Act 1962 (see Figure 4), was to restrict the numbers of Black people entering the U.K. and this could be seen as an attempt to appease the racist element in the U.K. at that time.

Net immigration in the 1950s and 1960s diminished in the 1970s and was related to levels of unemployment. Peach (1982) clearly demonstrates, for example, that West Indian migration was inversely correlated with unemployment. According to Brown (1984), immigration was highly concentrated geographically, industrially and occupationally.⁷ Thus the labour supply during 1960s and 1970s was met both by the large-scale immigration of people from the New Commonwealth and Indian-Pakistani region and the increasing return of married women to the labour market.

Sivanandan (1976) contends that the combination of 'laissez-faire immigration and laissez-faire discrimination' following the Second World War led to severe social problems. The riots of 1958 and the growing militancy of a Black underclass were taking on political proportions that the government, irrespective of party, could not ignore.

⁷ Industrial and occupational segregation also applied to women's labour (see Adams and Harte, 1998).

No doubt concerned by race riots in the United States (see Jenkins and Solomos, 1989), the government continued to try to integrate immigrant communities through new legislation, in particular the Race Relations Acts and the Equal Pay Act of 1970 which was concerned with pay differentials between women and men. Overall it would seem that during this period the government attempted to maintain control in the face of social unrest by passing legislation.

However, the 1965 and 1968 Race Relations Acts have been criticized for being primarily concerned with making symbolic gestures towards anti-discriminatory principles, but paying little attention as to how such principles should be implemented in practice (see, e.g., Wainwright, 1979; Sivanandan, 1982; Solomos, 1989). These Acts were presented as promoting good race relations through the legal prohibitions on discrimination at the same time that regulation of ethnic minority immigration was becoming increasingly restrictive (Solomos, 1989). The 1965 Act did not cover employment, one of the main arenas in which discrimination took place, and while this was remedied by the 1968 Act, enforcement powers were still lacking. This omission led Wainwright (1979) to describe the act as procedurally ineffective. The 1968 Act was also criticized for its concentration on individual (as opposed to structural) forms of discrimination and the lack of resources for implementing the law fully.

A gap existed between policy and practice. This was pointed out by numerous government and academic studies during the late 1960s and early 1970s (see Solomos, 1989, and Lea, 1990). There remained significant differences between Black and white people in the types of work carried out, pay and levels of unemployment. Empirical research indicated that high levels of discrimination persisted and this was taken to imply that the efforts of the Race Relations Board, which together with the Community Relations Commission was set up by the 1968 Act, had produced little or no change (Smith, 1979). Civil disturbances were exacerbated by the lack of trust and frustration that grew from the gap between policy and practice.

As well as being influenced by specific problems in the U.K., the government also came under pressure from developments in the United Nations. In 1969, for example, the United Nations General Assembly designated 1971 the 'International Year to Combat Racism and Racial Discrimination'. This was developed into the 'Decade for Action to combat Racism and Racial Discrimination', commencing in 1973.⁸ However, despite these international developments, the International Labour Organization Convention III on Discrimination in Employment and Occupation of 1958 was not ratified in the U.K. (see Forbes and Mead, 1992).

The underlying philosophy behind equal opportunities policy developments in the U.K. during this period was based on what has been called a 'colour-blind approach', a policy which gave equal access and equal treatment but failed to recognize the historical and contemporary reality of ethnic minority groups' experiences or to acknowledge their different needs. The approach rested on the premise that

⁸ This was followed later by a second and third decade.

to treat Black workers as different was to discriminate against the white population and was echoed by trade unions in the 1950s and 1960s (see Wrench, 1989).

There are a number of important observations that we can take from this first period. First there appears to be a strong historical link in the U.K. between immigration and economic expediency. In particular, the immigration policy during this period seems to be closely linked to the market demand for labour. Labour shortages were of particular concern in banking which, like the rest of the service sector, grew rapidly during this period (see Adams and Harte, 1998). Secondly, it would seem that the influx of ethnic minorities into the U.K. in order to meet these labour shortages contributed towards race riots early in the period. There seems to be a link between the immigration and equal opportunities policies that emerged during this period and these instances of social unrest. Yet while immigration was linked to labour shortages it would seem that little real consideration was given to equal opportunities in employment and the legislation that did emerge was criticized for its lack of substance and enforcement powers. Finally, it is important to point out that these policies did not take into consideration the structural disadvantage of ethnic minorities. Given the social and political context during this period, it would have been surprising to find disclosures on equal opportunities despite the immigration policies related to economic requirements, racial discrimination and riots.

PERIOD TWO, 1976–1990: DISCLOSURE BEGINS

This period is characterized by some disclosure by a minority of companies of equal opportunities policies specifically mentioning race and/or ethnic minorities. The period begins in the year after the publication of *The Corporate Report* (Accounting Standards Steering Committee, 1975) in the U.K. While recommending that companies produce employment reports disclosing the age distribution and sex of employees, it remained silent on ethnic minorities. During this period some limited references to race and ethnic origin in equal opportunities policy statements are evident (Figure 5). Marks and Spencer were the first to make any relevant disclosures by including reference to colour and race in their (albeit very brief) policy statements of 1976–82. They stopped doing this between 1983 and 1987, commencing again in 1988. Campbell (2000) in his longitudinal study of social disclosure at Marks and Spencer argued 'that marginal variability of disclosure can be explained by the varying perceptions of reality of successive Chairmen' (p. 80). This does not, however, appear to have been a factor in disclosure on ethnic minority employment which began part way through Lord Sieff's chairship (1973–85), finished before the end of his term of office and then recommenced part way through Lord Raynor's chairship (1985–91).

Of the banks disclosing during this period, the Nat West was the first to mention race in its equal opportunities policy statement in 1981. However, they made only three equal opportunities disclosures in total during this period. The Midland first mentioned ethnic minorities in 1988 and Lloyds also referred to race and colour in its 1988 equal opportunities policy statement. The only disclosures other

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FIGURE 5

EQUAL OPPORTUNITY DISCLOSURES WHICH SPECIFICALLY MENTION RACE OR ETHNIC ORIGIN, ETHNIC MINORITY POPULATION DATA AND KEY EVENTS: PERIOD TWO

Date	Retail	Banking	Population data	Key events
1976	M&S			Race Relations Act creating Commission for Racial Equality
1977	M&S			
1978	M&S			
1979	M&S			Southall: National Front allowed to meet in town where vast majority of population was Asian; very heavy police presence; force used. Anti-racist activist murdered
1980	M&S		2.2 million (4.1%) Black people in population (OPCS, 1981). In the year to August 1980, unemployed Black workers rose by 48% as against 38% of total unemployed (Home Office, 1982).	Riots in St Paul's, Bristol
1981	M&S	Nat West	Unemployment in 16-29 age group was 15.7% for white males and 36.7% for Black males (Labour Force Survey, 1981). The percentage total unemployed in the population was 8.2% (Central Office of Information, 1993).	Brixton and other riots. Scarman report (Scarman, 1981)
1982	M&S			
1983				
1984		Nat West	Policy Studies Institute (1984) published findings that the median wage for white men (women) was £20 (£4) higher than for West Indians and £18 (£3) higher than for Asians.	
1985	Boots			Riots in Tottenham, Brixton and Toxteth
1986		Nat West ^a		
1987				
1988	M&S, Woolworth	Lloyds, Midland ^a	Average % of ethnic minority persons in employment in 1987-89 was 4.7%. Average unemployment rates for the same period were 9% for whites and 14% for ethnic minorities. ^b	
1989	Boots, M&S, Woolworth	Lloyds, Midland ^a		
1990	Boots, M&S, Woolworth	Lloyds	The percentage total unemployed in the population was 8.1% (Central Office of Information, 1993).	British Nationality (Hong Kong) Act 1990; 'exceptionalist' legislation to grant full British citizenship status to 50,000 heads of households in Hong Kong (Jowett <i>et al.</i> , 1995)

^a Disclosure is more than just an equal opportunities policy statement.

^b *Employment Gazette* (1991).

SOCIAL REPORTING ON ETHNIC MINORITIES

FIGURE 6

RACE AND IMMIGRATION LEGISLATION, 1976-1990

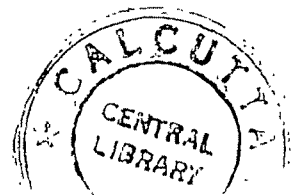
Race Relations Act, 1976: Formed Commission for Racial Equality and attempted to deal with institutionalized racism and unintended forms of discrimination. Incorporated a procedure for complaints to be handled by Industrial Tribunals.

British Nationality Act, 1981: Revised the Immigration Act of 1971 as regards the right of abode in the U.K. This Act set out different types of British citizenship and nationality. Not all of them gave a person the right to live and work in Britain.

than these very bland and brief policy statements in this entire period were a reference by the Nat West to ethnic monitoring in 1986 (see below) and two brief references by the Midland. The first in 1988 was to the appointment of an equal opportunities director. Midland explain that this appointment was designed 'to ensure that the potential of women in the group is fully realized, and that our recruitment and subsequent treatment of people from all sections of the community, including ethnic minorities and the disabled, are even-handed'. This statement does, however, appear to be more specifically related to the position of women within the company. The second disclosure in 1989, however, is more directly related to ethnic minorities. The company stated: 'In 1989, the Group launched CAMPUS, a university scholarship scheme. It was introduced particularly for women and employees from ethnic minorities who have not hitherto had the opportunity to attend university. The programme aims to bring its participants quickly to a level where they can be considered for management opportunities.'

Although there was no significant change in the level of ethnic minority population in Great Britain during the 1980s, Figure 6 reveals that two new pieces of regulation were implemented during this period.

The Race Relations Act of 1976 represented 'a strengthening and extension of existing anti-discrimination policy rather than a new and unfamiliar policy' (Nixon, 1982, p. 366). The most important developments were, first, an extension of the objectives of the law to cover systemic as well as intentional discrimination. The Act defined 'indirect' forms of racism and rendered such forms of discrimination illegal. Second, it re-organized the Race Relations Board and the Community Relations Commission into a joint state agency that would be known as the Commission for Racial Equality (CRE) (see Blakemore and Drake, 1996, for a discussion of its powers). Third, a new procedure for handling individual complaints of discrimination was introduced. Employment cases were to be handled directly by industrial tribunals rather than processed through a body like the Race Relations Board. The CRE was charged with the formulation and issuing of codes of practice aimed at eliminating discrimination. These codes were not, however, approved by ministers until well into the 1980s. Though the government had promised an 'effective race relations policy', like its predecessors, the 1976 Act was widely criticized for having little or no substantive impact on discriminatory practices in employment (see, e.g., Karn, 1997; Rose, 1990).



Prior and subsequent to the election of Margaret Thatcher's Government in 1979, the late 1970s and early 1980s witnessed a significant intensification in the issue of race. As Cheung-Judge and Henley (1994, p. 3) contend, 'within a decade, the idea of equal opportunities changed from a sleepy ideological abstraction to a controversial and high-profile fact of life'. This was a direct result of the surge in unemployment in the U.K. at the beginning of the 1980s and the related social unrest (see Figure 5). As leader of the opposition in the late 1970s, Margaret Thatcher spoke out in favour of an end to immigration, arguably in a direct response to the perceived escalating *fears* of the white majority (see Bowling, 1996). By 1980 unemployment rose to two million for the first time since 1938, spiralling to three million by 1982. Unemployment amongst ethnic minorities was disproportionate to the rest of the indigenous white population and discrimination in employment experienced by Black workers increased as the economic depression intensified (see Rhodes and Brahams, 1989). Yet there was a widely held perception that immigrants had contributed to the unemployment amongst white British citizens and this fuelled unrest. The events in Southall in 1979 indicated that the equal opportunities legislation developed in response to the social disorders of the late 1950s was no longer tenable. The urban disorders of 1980, 1981 and 1985 added weight to the growing view that notions of colour blindness were deficient (see Bagilhole, 1997). The government response to the events in Southall and the Scarman Report of 1981 following the Brixton riots of 1981 was widely claimed to be wholly inadequate (see, e.g., Benyon, 1984; Solomos, 1989; Bowling, 1996). There was considerable mistrust of the police by ethnic minorities and the existence of bodies like the Southall (Police) Monitoring Group⁹ reflected fears that racism within the force had become institutionalized.

The government's anxiety subsequent to those urban disorders was intensified by an appreciation that the political left saw these events as evidence of the revolutionary potential of racialized minorities (Jewson, 1990). Instead of simply promoting solidarity with the working class, alternative sources of collective identities were being recognised as important. These included women, ethnic minorities and disabled people and this was reflected in policies adopted by a number of Labour-controlled local authorities. Central (Conservative) government attacks on the power of local authorities came in response to the priority which local authorities gave to equal opportunities issues (Bagilhole, 1997). It may also be significant that Black organizations such as the Indian Workers' Association, the Black Workers' Rights Committee and the Black Trade Unionists' Solidarity Movement were beginning to engage with trade unions in an endeavour to find commonalities and change attitudes, although examples of racism within the trade union movement could still be found (see, e.g., CRE, 1981).

The response of the political right at the time is clearly expressed in Enoch Powell's claim that 'the market economy . . . is the most effective enemy of discrimination between individuals, classes and races' (Foot, 1969, p. 129). There was

⁹ It was still apparent as recently as the 1990s, following police handling of the murder of Black teenager Steven Lawrence.

a renewed emphasis on British nationalism and the claim that Britain was being swamped by ethnic minorities (Bagilhole, 1997) and the very necessity for bodies like the CRE and Equal Opportunities Commission (EOC) was questioned by sources close to the government. There was also entrenched resistance by government against the implementation of equal value amendments to the Equal Pay Act in the wake of initiatives emanating from the European Community (Bagilhole, 1997).

Smith (1979) provides some insight's into some corporate attitudes during this time. He found that employers did not think there was a need for equal opportunities reporting because they believed the white majority did not perceive a problem of discrimination in the workforce. Smith (1979), however, argues that: 'the assumption that there is no discrimination is unjustified; the suggestion that racial questions do not lead to management difficulties evades the issue which is whether unfair treatment has been prevented irrespective of whether the victims of such treatment would cause trouble from the management point of view'. In summarizing his results, Smith states that managers he interviewed lacked general awareness and understanding of law, tended not to think analytically about their recruitment and promotion procedure, and because of this they often avoid facing up to the implications of what they are doing.

Despite Smith's findings, we did identify some disclosure on ethnic minorities during this period. Drawing from other works, there may have been a number of reasons why companies started to develop equal opportunities policies for ethnic minorities during this period. All of these possibilities may be related to the general increase in social awareness of racism subsequent to the social unrest of the 1980s. First, they may have developed in an attempt to pre-empt legal disputes (Jenkins, 1986, 1989). Such a motive is apparent from policies which take a legalistic form and identify minimum lawful behaviour by managers (see Jewson *et al.*, 1992). Second, the research suggests that they may have been developed in order to improve perceptions of the organization, either among its employees, its customers or lenders (Jenkins, 1986, 1989). This would include organizations wanting to preserve a reputation for good employment practice whose policies went beyond the legally required minimum (see Jewson *et al.*, 1992; Jewson and Mason, 1993). Finally, existing research suggests they may have been developed as a direct response to a 'race' problem within the company, such as an unfavourable Industrial or Employment Appeal Tribunal decision, a 'race'-related industrial relations problem or pressure from local community groups or the CRE (see Jenkins, 1986, 1989; Jewson, 1990; Jewson *et al.*, 1992; Jewson and Mason, 1993). While many of these reasons, can be categorized as 'defensive or reactive' strategies (Jenkins, 1986), companies were becoming increasingly proactive in protecting their reputation and Jewson and Mason (1993) point out that some companies were beginning to appreciate the commercial benefits of having an equal opportunities policy (see Adams and Harte, 1998; Porter, 1985). The Midland Bank, for example, specifically referred to the clear commercial benefits to be gained from making the fullest possible use of all its staff resources in connection with being an equal opportunity employer in its 1985 corporate annual report. However, the

existence of a policy in itself was obviously not sufficient to ensure action and outcomes (see Jewson and Mason, 1989) and this led to the development of ethnic monitoring practices.

Jewson and Mason (1993) contend that there were some (anonymous) companies well known in the 1960s and 1970s for policy innovations based on more general *principles* of equality. However, in our sample, reporting on such developments occurred much later and appears to have been motivated by the CRE's concerns that good head office company policy statements were not always being translated into procedures and results at branch level. For example, after the Code of Practice came into effect in April 1984, the Commission approached thirty of the largest private sector employers in the U.K. They contacted, for example, Halifax Building Society, the four clearing banks and W. H. Smith to identify the steps that were being taken to meet the recommendations in the code and, where possible, to advise and assist. Also, by 1984 many of the largest high street retail chains had started to monitor recruitment, following the lead set by companies such as Littlewoods and Marks and Spencer. Several companies were also starting to review their promotion procedures (CRE Annual Report, 1984). The clearing banks, including Nat West, Barclays and Midland, began ethnic monitoring in 1985. These banks circulated detailed guidance on their equal opportunities policies to staff and since January 1985 all job applicants have been asked to record their ethnic origins. The Royal Bank of Scotland had incorporated an ethnic origin question into its application form and the Halifax Building Society also began to obtain information on ethnic origin from both its existing staff and new applicants. In the retail sector, Safeway Food Stores, for example, started monitoring to make sure its race relations policy was effective. Finefare, W. H. Smith and the British Shoe Corporation were also working towards setting up monitoring systems (CRE Annual Report, 1985).

Many of these initiatives, however, do not appear in the companies' annual reports. In fact, the first mention of ethnic monitoring by our sample companies was the *only* mention in this period up to 1990. It was made by the Nat West in the director's report in their 1986 annual report: 'In line with the Commission for Racial Equality's Code of Practice, the bank carried out an exercise whereby all staff were invited to participate in the identification of an approved ethnic category. The information so obtained will assist the Bank to monitor the effectiveness of its equal opportunities policies to ensure the objectives are being achieved.'

The lack of reporting prior to 1986 concerning ethnic monitoring may reflect Hitner *et al.*'s (1982) findings regarding lack of management commitment to these kinds of programs. Their study found such initiatives to be very few in number. Those that were found went little beyond formal statements of intent and were not systematically incorporated into day-to-day practice. In many cases this lack of incorporation reflected their reactive character and often led to further managerial problems (Hitner *et al.*, 1982). Moreover, there was a tendency to see discrimination as a product of the behaviour of prejudiced individuals. There was little appreciation of the existence of systematic and structural disadvantage and discrimination.

During this second period Littlewoods, Nat West and NorWest Gas started a one-year 'Access to Business' course for Black candidates without academic qualifications that included a twelve week work experience placement. The CRE also worked with Woolworths on a survey of branches to examine recruitment in new selection and in equal opportunities training (CRE Annual Report, 1986). Yet, like other companies in the sample, the annual reports of the Nat West and Woolworths were silent about these developments.

In conclusion, the second period from 1976 to 1990 witnessed some significant developments in equal opportunities as well as limited increases in reporting. During the period increased levels of unemployment accentuated racial tensions. Although the government's main policy for dealing with this social unrest involved passing new legislation, the CRE did begin to work more closely with business in attempting to combat racial inequality. It would seem more than accidental that the first reporting on ethnic minorities coincides with the passing of the 1976 Race Relations Act, growing civil unrest and a shift in perspective away from 'colour blindness' (Bagilhole, 1997). The election of Margaret Thatcher as prime minister in 1979 and the major shift in ideology and economic policy which this represented is a significant factor in understanding the increased involvement of business in the management of racial tension (see, e.g., Miller and Rose 1991; Ezzamel and Willmott 1993; Humphrey *et al.* 1993). However, at this stage the managerialist discourse emerging around this issue was not sufficiently developed for companies to report to the market on the policies they had implemented.

PERIOD THREE, 1991–1998: SIGNIFICANTLY INCREASED DISCLOSURE

During this period, the majority of companies reported in each year with a number making disclosures other than policy statements. It is characterized by two developments. First, there was an increase in the number of large firms adopting equal opportunities policies. And second, there was a significant increase in the volume of disclosures on policy statements in corporate annual reports, along with some reporting on efforts to improve opportunities for ethnic minorities, and outcomes of the monitoring process (see Figure 7). From these disclosures it is apparent that some managers construed the issue in terms of potential commercial benefits for their company.

The 1990s witnessed significant development in the relationship between the CRE and private sector companies. In 1990, at a time of labour shortages and recruitment difficulties in the retail sector, the CRE continued to monitor and assist major companies in developing and implementing equal opportunities initiatives and policies. Notwithstanding the government's attempts in the 1980s to 'roll back the state', the early 1990s witnessed a Conservative minister of employment vigorously endorsing the principles of equal opportunities policy. At a more fundamental level, growing support for equal opportunities policies from all the major political parties might be seen as one aspect of a broader change or evolution in the relationship between State and economy in Britain. As government

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FIGURE 7

EQUAL OPPORTUNITY DISCLOSURES WHICH SPECIFICALLY MENTION RACE OR ETHNIC ORIGIN, ETHNIC MINORITY POPULATION DATA AND KEY EVENTS: PERIOD THREE

Date	Retail	Banking	Population data	Key events
1991	Boots, M&S, Sears, W. H. Smith, Woolworth	Barclays*, Clydesdale, Lloyds, Midland*, Nat West*	Of the working population 4.3% of women and 4.6% of men were from ethnic minorities compared with 5.7% and 5.3% of working age ethnic minorities in the population (Owen, 1997).	
1992	Boots*, Sears, W. H. Smith, Woolworth	Bank of Scotland*, Barclays, Clydesdale, Lloyds, Nat West, Royal Bank of Scotland		
1993	Boots*, Burton, Sears, W. H. Smith, Woolworth	Bank of Scotland*, Clydesdale, Lloyds, Nat West, Royal Bank of Scotland		
1994	Boots, Kingfisher, Sears, W. H. Smith	Bank of Scotland*, Barclays*, Lloyds, Midland*, Nat West*, Royal Bank of Scotland*		
1995	Boots*, Kingfisher, M&S, Sears, Storehouse, W. H. Smith	Bank of Scotland*, Barclays*, Lloyds TSB*, Nat West*, Royal Bank of Scotland		Race for Opportunity campaign
1996	Boots, Kingfisher, Sears, W. H. Smith*	Barclays*, Lloyds TSB, Nat West*, Royal Bank of Scotland		
1997	Boots, Kingfisher, M&S, Sears, W. H. Smith	Barclays*, Lloyds TSB*, Nat West*, Royal Bank of Scotland		Labour government elected
1998	Boots*, M&S, Kingfisher, W. H. Smith, Sears*	Barclays*, Lloyds TSB*, Nat West*, Royal Bank of Scotland*		

* Disclosure is more than just an equal opportunities policy statement

'rolled back the state', more and more areas of economic and social life were subject to market forces or privatization (see, e.g., Miller and Rose, 1991; Ezzamel and Willmott, 1993; Humphrey *et al.*, 1993). In one sense this did involve less state intervention. However, the faith in free-market economics simultaneously drew government into the formulation and implementation of frameworks of regulation and control monitored by specialized state agencies like the CRE (Veljanovski, 1991). The 1990s were characterized by an increasing degree of cooperation between both private and public sector companies and the CRE in developing

equal opportunities policies and programs. Top level meetings were held with W. H. Smith, Boots, Sainsbury's and British Gas, all of whom agreed to work more closely with the commission.

In April 1991, a CRE member of staff was seconded to Boots for six months to help the company increase the effectiveness of their equal opportunity policy. A senior manager at Boots was also seconded to the commission in 1991. Boots state in their 1992 director's report: 'In 1991 we introduced ethnic monitoring to enable us to understand the profile of our employees and to plan appropriate action. We have worked closely with the Commission for Racial Equality with a senior secondee from that organization to help us in our task.' Boots was one of the more active companies during this period; however, their commitment may be partially due to the fact that Boots chair, Sir James Blyth, was also chair of the Prime Minister's Advisory Panel on the Citizen's Charter. The personnel director and the managing director, who had previously served as a personnel director, were also on the board.

None of the other retail companies in our sample mentions ethnic monitoring and only two companies, Barclays and Nat West, report the *outcome* of their monitoring. Nat West's 1994-96 annual reports disclose that 2 per cent of the bank's management team are ethnic minority employees. This compares with 1991 census figures of 5.7 per cent and 5.3 per cent ethnic minority men and women respectively in the working age population (Owen, 1997). By 1997 the percentage in the bank's management team had increased to 2.5 per cent and by 1998 to 3 per cent. The 1991 annual report of Barclays included a bar chart showing the percentage of ethnic minority staff across six grades in both 1988 and 1991 showing modest improvements across all but the lowest grade. They stated: 'In the U.K. approximately 5% of the working population comes from ethnic minority groups and, whilst in general this is reflected in the Group's staff, monitoring of recruitment and career progression will be a key factor in policy development'. In its 1991 report the CRE notes that it assisted in the implementation of equal opportunities policies by retail employers through a series of seminars in which ASDA made a leading contribution.

The banking sector also saw some positive developments despite the recession. The Midland Bank launched a positive action scheme: the Midland Fellowship Programme, for ethnic minority undergraduate students. This was to provide quality paid work experience over six to eight weeks during the summer vacation for up to thirty placements. While this training course for ethnic minority students was not mentioned in their accounts, the chief executive's statement in the 1991 report did mention a training course aimed at ensuring its staff better understood the needs of its ethnic minority customers. They stated: 'there are areas of the country that have a very strong ethnic minority presence in the business community. Working closely with the Ethnic Minority Business Development Team, a Home Office initiative, a training programme has been created to ensure that Midland staff better understand the needs of the people concerned.'

In May 1991 the TSB launched a new Equal Opportunities program. The Nat West also set up an internal Ethnic Minority Advisory Group and introduced a

cultural awareness training program for its training staff. Lloyds Bank also consulted the CRE on a review of its recruitment policy (CRE Annual Report, 1991). However, none of the banks mentioned these initiatives in their reports, although Lloyds did briefly mention its support for the Race for Opportunity campaign aimed at improving opportunities for ethnic minorities in its 1995, 1997 and 1998 reports. Barclays also mentions support for Race for Opportunity in its 1998 report. They say, 'the Group . . . supports . . . the "Race for Opportunity" campaign which encourages businesses to invest in the diversity of Britain's ethnic minority communities' (p. 79). The Race for Opportunity campaign organized by Business in the Community was launched in 1995 following research and consultation with businesses, ethnic minority groups and public sector organizations (see Bann, 1998). It stresses the mutual benefits to the economy and ethnic minority groups of businesses 'investing' in diversity. Companies which sign up to the campaign commit not only to adopting a policy, but also to detailing how it will be actioned and to evaluating progress and reporting annually on results.

Given the continuing recession, it seems that the emphasis for the banking sector was on achieving good employment practices. During the year, progress meetings were held by the CRE with five major High Street banks. The Nat West agreed to set targets for the recruitment and promotion of ethnic minority staff and publish ethnic origin data in its annual report. It made a training video explaining target setting and positive action to staff, introduced diversity training for managers and ran self-development courses for women in lower grades. The TSB Group reported to the CRE an increase in ethnic minority employment from 2.4 per cent in 1990/91 to 2.7 per cent in 1991/92 although the company did not disclose these figures in their annual report. It set an objective of increasing this to 3.2 per cent by 1994.

Midlands, Barclays and TSB also participated in a forum for an exchange of views on joint work to maximize the benefits of equal opportunities programs. In Scotland the second Access to Banking Course was successfully implemented, resulting in ten ethnic minority trainees securing jobs in June 1992 with the four sponsoring banks (CRE Annual Report, 1992). The Bank of Scotland and the Royal Bank of Scotland made passing references to these initiatives in their 1994 annual reports.

During 1992 Safeway, Marks and Spencer, Debenhams and Tesco received assistance from the CRE in implementing equal opportunity policies. At corporate level, the CRE held meetings with W. H. Smith and J. Sainsbury. The CRE report notes that several employers made encouraging progress in implementing their racial equality programs through staff training, recording ethnic origin of employees and applicants, analysing data, setting targets and taking positive action to attract and train ethnic minority personnel. For example, Littlewoods ran positive action training for management trainees. The company went further and took a significant step of requiring its suppliers to conform to this policy. B&Q took part in a similar positive action scheme. Tesco set up a Directors Equal Opportunity Group. Marks and Spencer also received assistance from the CRE; however, they make no reference to this in their annual reports. W. H. Smith also simply states in its 1996 report: 'The Group has worked with the Commission for Racial Equality and the Equal

Opportunities Commission to ensure that its practices are of the highest standard'. Boots is the only retail company in our sample to explicitly mention support for Race for Opportunity, doing so in its 1998 annual report. They say: 'Boots has maintained its active involvement in Race for Opportunity, developing and sharing good practice at national and local level. It has held seminars for East Midlands employers on employment and purchasing and provided practical and financial support for the first East Midlands Trade Fair for Ethnic Minority Businesses.'

From the examples mentioned in this section, it seems that this third period of analysis is characterized by an apparent shift in management attitude towards equal opportunities reporting despite the fact that companies did not always seem to communicate their apparent commitment to equal opportunities through their annual reports. The indifference that Smith (1979) found would appear to have been replaced by a more active engagement with equal opportunities issues. However, despite noting this progress, the CRE 1992 Annual Report concluded that 'it was clear that in the retail sector in general the gap between policy and local practice remained wide'.

In telephone interviews researchers at the CRE in London and Edinburgh told us that they questioned both the commitment and the motives of employers. Where there was a reasonable level of commitment they felt it came from a belief that 'diversity strategies', as human resource people were calling them, were good for business (see also Kandola *et al.*, 1995). When asked their views on why the banks and other companies did not report, they said they felt it was because they did not want to be held accountable and that there was also an element of embarrassment and concern about adverse reaction from shareholders and white staff. The main reason for the increase in reporting during this period therefore seems to have come from the CRE's proactive attempts to get companies to engage with equal opportunities.

Amos and Ouseley (1994) argued that the 1990s have been characterized as the decade of equal opportunities in Britain. Indeed, the 1990s was a period in which a growing number of large firms, working with the EOC and CRE, elected to introduce or further develop formal equal opportunities programs. These were different in character to earlier *ad hoc* responses to the perceived special needs of ethnic minorities. They comprised written documents incorporating a variety of rules and regulations concerning employment relationships. In many cases they entailed a review of the entire recruitment and promotion process within the organization. The most elaborate examples included not only statements of intent, but also detailed instructions as to how these were to be translated into practice. Some endorsed ethnic monitoring and a few even began to set targets. Although the numbers of companies involved in these activities was relatively small, they do represent a significant group of large multinationals. Yet despite these apparent developments, it would seem that the increased involvement with the CRE and the consequent growth in equal opportunities reporting is related to attempts by the state to manage racism. While this strategy may entail very real benefits for ethnic minorities, it may ultimately lead to the depoliticization of the race issue and a reduced possibility of substantive change.

Bagilhole (1997) notes that increasingly in the 1990s, a business case was presented for equal opportunities. She argues that this case rested on two premises. First, that both private and public sectors of the economy were underutilizing the full opportunities for some (minority) groups in society. And second, that organizations could increase their efficiency and effectiveness by projecting a more pluralistic self-image that would appeal to a wider pool of potential customers. Joanna Foster, chair of the EOC, for example, linked equal opportunities in the 1990s with economic efficiency and social justice (see Ross and Schneider, 1992). Virginia Bottomley, who was Minister of State for Health at the time, communicated a similar perspective when launching a nationwide equal opportunities program for ethnic minority staff in the National Health Service. She stated: 'I want to stress that taking action to promote equality in employment is not just a matter of moral justice or of fairness to people from minority ethnic groups, it is good, sound common sense, and it makes business sense too. Otherwise the NHS will lose the benefit of their skills' (*India Mail*, 14–20 December 1993, in Bagilhole, 1997, p. 57). This managerialist reorientation of equal opportunities represents a significant shift in approach to managing the problem of race over the period in our study, a shift that has contributed towards the depoliticization of the race issue. This shift from legislation to the rhetoric of managerialism, we contend, has gone some way towards reducing the disruptive potential posed by racism (Young, 1990; Bagilhole, 1997). By translating equal opportunities into the economic language of managerialism and establishing action based on a corresponding set of administrative procedures there is a danger of losing perspective on the fundamental political and ideological issues which equal opportunities represents (Rattansi and Westwood, 1994; Bagilhole, 1997; Black and Solomos, 2000) and also undermining the logic of resistance (Gorz, 1989). The application of managerialist ideology has of course been linked to other perceived problem areas like the NHS (see e.g., Miller and Rose, 1991; Ezzamel and Willmott, 1993; Humphrey *et al.*, 1993).

The shift from legislation to a more proactive managerialist orientation by the Conservative government that took place during the 1990s has been linked to other economic and political expediencies. Some, for example, have suggested that the policy shift represented a search by the Conservative government for electoral advantage through attracting the votes of ethnic minorities, women and disabled people. Others have highlighted fears of further urban disorders (Bagilhole, 1997), and concerns over demographic trends, and anticipated labour shortages (Jewson *et al.*, 1992) as further reasons behind the policy shift.

In conclusion, the developments in ethnic minority reporting during the 1990s took place within the context of considerable social unrest and increasing international pressure to address racial prejudice. These changing social conditions resulted in a significant shift in government policy on equal opportunities from legislation to managerialism. Government agencies actively encouraged business to engage with the race problem and this strategy appears to be related to the significant increase in the quantity of reporting on ethnic minorities amongst the companies in our sample. It is also significant that many companies did not disclose their EO initiatives and policies in their annual reports.

DISCUSSION AND SUMMARY

The three time periods examined were based on the pattern of corporate disclosure on ethnic minorities that emerged. In the first period the 'colour blind' approach seems to have contributed towards a complete lack of disclosure. However, it would appear that this perspective gave way to a period of changing attitudes when a series of race riots and growing international concern over racism in general made it clear that a colour-blind approach was no longer tenable. The government initially adopted a legislative approach to dealing with racism, evidenced by simple policy statements on equal opportunities beginning to appear in some company reports. In the third period there seems to have been an increasing emphasis on the business case for equal opportunities. We contend that the increase in corporate disclosures is indirectly related to the changing political discourse and the proactive efforts by the CRE to engage companies in the equal opportunities agenda. We suggest that this shift represented a change in approach by the state towards the race problematic.

While several companies did seem to make a serious effort to tackle structural as well as direct racism in their employment practices, it was found that these efforts were not fully reflected in their corporate reports. We suggested that these omissions reflect first, a concern that the market would penalize companies who appeared to take equal opportunities too seriously, and second, in the case of companies who nevertheless were concerned, a desire to avoid being held fully accountable. As such, the nature of companies' disclosure may reflect their attempts to negotiate potentially conflicting discourses.

In conclusion then it is contended that the identified patterns of disclosure and nondisclosure can be understood, in part at least, as reflecting the broader socio-political context within which they occurred and, more specifically, the changing political discourses surrounding the race issue in the U.K.

It was noted at the beginning of the article that Marxist theory has traditionally provided the lens through which critical researchers have studied the race problematic. Applying this conventional Marxist perspective, particularly to the first two periods here, would lead to one of two possible conclusions in relation to the socio-political context behind patterns of disclosure: firstly, that the race problematic in general was an active bourgeois *strategy* for managing the exploitation of labour (Cox, 1970); or, alternatively, that it was a *symptom* of capital's exploitation of labour that subsequently had to be managed (Banton, 1987). A brief comment is provided on whether either of these positions is consistent with the findings reported here.

Cox (1970) contends that race discrimination is an active bourgeois strategy for managing the exploitation of labour. In his classic Marxist analysis he defines racial prejudice as 'a social attitude propagated . . . by an exploiting class for the purposes of stigmatizing some group as inferior so that the exploitation of either the group itself or it's resources or both may be justified' (Cox, 1970; see also Miles, 2000). He contends that this historical process originated in the colonial and imperialist phases of the development of capitalism.

The current study does not allow comment on the validity of Cox's analysis in general, but it does seem to us that there has been a perceptible shift in racism as it exists in the late form of capitalism we studied in the U.K. In particular, Cox does not provide much help in understanding the establishment of the CRE, the advent of the managerialist discourse on equal opportunities, or the emergence of corporate reporting. The disclosures identified here and the broader managerialist discourse do not appear to stigmatize racial minorities. Indeed, Cox's traditional, functionalist interpretation has been criticized by others for failing to elucidate the extent of racial hatred seen in many of the race riots (Bowling, 1996; Pilkington, 1996). This antipathy may not be related to economic expediency alone (Rex, 2000). Research by Adams and Harte (1998), for example, has found that the corporate annual report has been used by management as a political tool to maintain the status quo regarding gender differences in employment even where this has been contrary to capitalism's economic interests. There is similar evidence in our study. During the first period, for example, racial tension seems contra to capital's requirement for labour. In the first period, demands for restrictions to the employment of Black people by white workers and trade unions continued during labour shortages (Wrench, 1989). Some of the most violent rioting also took place during periods of labour shortage (see Bowling, 1996, and Pilkington, 1996).

Banton (1987) provides an alternative Marxist perspective on the race issue. His contention that the requirement to manage the threat of racism arises *because of* capital's exploitation of labour does provide some insights for understanding the development of the race issue in the U.K. Yet while the immigration policies developed in order to satisfy capital's requirement for labour might have exacerbated racial tension in the U.K., we contend that the complexity of this issue cannot be fully captured by the dialectic between capital and labour. It is also suggested that Banton provides little help in understanding either the nature of the threat of the racist problematic or the ways in which this complex issue is mediated.

Recognizing these difficulties, theorists like Stuart Hall (see, e.g., Hall *et al.*, 1978, and Hall, 1978, 1980) have suggested that the racism can more usefully be approached from a cultural theory perspective and in particular through what has been termed 'the politics of difference'. This phrase refers to a requirement to maintain the *otherness* of subjugated minority cultures so essential to the dominant self-identity, yet simultaneously manage the threat they pose. Central to this perspective is the role that the discursive construction of identity plays in managing ideological conflict. This cultural theory perspective is elaborated below together with an analysis of the insights it provides into the findings reported here.

From the findings above we suggest that the racist crisis in the late form of capitalism in the U.K. was mediated in different ways. Also, these different strategies reflect two different kinds of threat that emerged. It would seem that initially the threat came from riots, violence and social unrest and that the state attempted to manage this crisis through legislation. However, the events in the last period might be related to a different kind of threat than that highlighted by Banton

(1987). Rattansi and Westwood (1994) explain that the danger of racial exploitation in late forms of capitalism comes not primarily from the threat of violence, but rather from its unsettling delegitimation of both the capitalist grand narrative and its subjugating self-identity. They explain that the 'series of racisms', which may have helped define who we in the West are, haunt us with the spectre of contradiction: Our developed, advanced, enlightened, educated society is intrinsically racist (Rattansi and Westwood, 1994; see Goldberg, 2000; Bauman, 1996). Rattansi (1994) elaborates: 'Western modernity represents itself as civilized, and therefore as a project of, "humanity against barbarism, reason against ignorance, objectivity against prejudice, progress against degeneration, truth against superstition, science against magic, rationality against passion," and more especially projects a mythology of itself as a tamer of cruelty and violence'. It would seem that both the International Year to Combat Racism and Racial Discrimination and the Decade for Action to combat Racism and Racial Discrimination from 1973 to 1983 are examples of this kind of growing awareness that the existence of racism contradicts the West's claim to be developed and civilized.

Rattansi (1994) contends that this self-conception has emerged from, and is sustained by, the different, 'other', kinds of *savages* encountered, subjugated and *civilized* during decades of colonial, imperialist rule. That is, our conception of ourselves in the West as being developed, educated, civilized and reasonably advanced may be derived as much from what we are not as from what we are: how we differ from others rather than what we are essentially in ourselves. Indeed, there may be a sense in which we continue to require these other, different, people to sustain the character and pretence of our own enlightened, objective, advanced identities (see Rattansi, 1992, 1994). From this perspective, maintaining the otherness of subjugated minority cultures may be an essential part in any attempts to integrate and manage the threat they pose.

Having elaborated on the nature of the race problematic in late capitalism, Hall (1980) proceeds to discuss how that threat is mediated. He draws on the dialectic of difference, outlined above, to explain the rise in the authoritarian state in the U.K. over the past few decades and the changing *modus operandi* in its approach towards racial tension. Hall's arguments seem to resonate with our findings. These results indicate the changing ways in which the state has attempted to engage with the racial problematic over time, moving from more overt forms of regulatory control to hegemonic forms of discursive transformation (Goldberg, 2000). Drawing on Foucault's concept of power/knowledge (McPhail, 1999; Foucault, 1970, 1977), it might be possible to hint at the characteristics of this broader managerialist discourse and this may help clarify Rattansi and Westwood's (1994) proposition. In particular it may help in understanding the ways in which this discourse may be seen to maintain the *otherness* of minority cultures while simultaneously assimilating ethnic minorities into the dominant culture (Robson and Cooper, 1989).

Foucault's power/knowledge is in part a recognition of the complex ways in which individual subjectivities emerge as objects through specific discourses (McPhail, 1999; Foucault, 1970, 1977). Foucault posits, however, that subjects

rarely emerge in isolation from other discursive objects. Rather, he contends that discourses categorize and order, and by so doing are intrinsically about difference. As Goldberg (2000) contends, 'racial knowledge consists in the making of difference'. Foucault (1970) explains:

All knowledge, of whatever kind, proceeded to the ordering of its material by establishment of differences and defined those differences by the establishment of an order; this was true for mathematics, true also for taxonomies . . . and for the sciences of nature; and it was equally true for all those approximative, imperfect, and largely spontaneous kinds of knowledge which are brought into play in the construction of the least fragment of discourse or in the daily process of exchange.

Goldberg (2000) contends that the racialized discourses of phrenology, IQ testing and crime statistics represent an example of precisely the kind of power/knowledge that Foucault elucidates (see Miller and O'Leary, 1987; Miller, 1989). If Foucault and Goldberg are correct, and the managerialist reorientation of equal opportunities is related to a broader (re)production and surveillance of racialized minorities, then the fragments of disclosure we discovered, the ethnic monitoring used by companies and discussed in their annual reports, the labels used and the knowledge these programs generated about specific categories of individuals, may reflect, and in some measure contribute towards, the establishment of differences between ethnic minorities and the prevailing culture. However, as well as establishing difference the broader managerialist discourse may also convey a sense of integration. The combination of integration and differentiation may serve to support the obvious superiority and magnanimity of the dominant self-identity. In an attempt to legitimate itself, the prevailing culture endeavours to represent itself as caring and empathetic.¹⁰ Although we suggest that corporate disclosure on ethnic minorities is only indirectly linked to the CRE's attempts to engage companies in the race problematic, we nevertheless contend that this *shadow reporting*¹¹ is significant because of the extent to which these disclosures reflexively contribute towards the transformation and sedimentation of the broader discourse surrounding the race issue in the U.K. (see Foucault, 1970, 1977; Burchell *et al.*, 1985; McPhail, 1999).

All of this does not, of course, mean that that the managerialist discourse on equal opportunities has not improved or does not have the potential to improve the position of ethnic minority groups. In *Discipline and Punish*, for example, Foucault (1977) explained how, within hospitals, new forms of knowledge contributed towards better health care, and yet also 'narrowed the possibilities for subjectification' such that patients were treated like objects. The managerialist discourse may have positive effects for minorities; however, both Foucault's and Hall's argument is rather that there is a danger that the race problematic becomes

¹⁰ For a more practical discussion of possible ways of developing the research, see Adams and Harte (1999).

¹¹ We use the term 'shadow report' to reflect our observation that the corporate disclosures we identified may represent a shadow caused by some broader change in discourse.

embraced within new discursive practices which may transform what is a potentially system threatening issue into at best a benign or even a system serving issue.

This article contributes to the literature on corporate social disclosure, particularly with respect to the employment of ethnic minorities in the banking and retail sectors in the U.K. from 1935 to 1998. Patterns of nondisclosure and disclosure were considered in light of changing social, political and economic environments. Further, we examined the appropriateness of a Marxist analysis, given that in the critical literature racism in the U.K. has been predominantly viewed from a Marxist perspective. A Marxist analysis does not fully explain nondisclosure, which may be related to social attitudes and changes in the state's approach, through the CRE, to managing the evolving threats of racism. These findings indicate the complexity of the influences on corporate social disclosure and how it is dependent on the particular type of disclosure being considered. It highlights the incompleteness of current corporate social reporting theories, particularly with regard to explaining nondisclosure.

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Opening of the R. J. Chambers Collection

Raymond John Chambers was the founding editor of *Abacus*. His standing as an accounting scholar is well documented. Less well known is that he assiduously assembled an archive of his correspondence and related papers with the accounting scholars of the world, the profession's leaders, government and the professional committees and tribunals addressing contemporary business and accounting education issues. He also kept detailed records of discussions he had with many—both those who shared his views and those who opposed them—regarding work he had in progress or was preparing to publish, his submissions to various committees, evidence before committees and tribunals. Exceeding 20,000 items, the correspondence and other papers relating to Professor Chambers' activities during the period 1947 to 1999 form the R. J. Chambers Collection.

The University of Sydney's Foundation Professors project, Fisher Library, the Faculty of Economics and Business, the Accounting Foundation at The University of Sydney and CPA Australia provided initial funding for archiving the Collection.

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The opening of the R. J. Chambers Collection will be followed by the R. J. Chambers Memorial Lecture, 2004, sponsored by the Accounting Foundation at The University of Sydney. Three distinguished international accounting scholars—Professor John R. Edwards from the Cardiff Business School, University of Wales; Professor Giuseppe Galassi, from the University of Parma, Italy; and Professor Gary Previts—will present their insights into the lessons to be learned from the history of accounting and their implications for current practice.



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